

No. 17313

United States
Court of Appeals
for the Ninth Circuit

FRANCIS L. ROONEY, and IRENE ROONEY,
Appellants,
vs.
UNITED STATES OF AMERICA,
Appellee.

Transcript of Record

Appeal from the United States District Court for the
Northern District of California,
Northern Division.

FILED

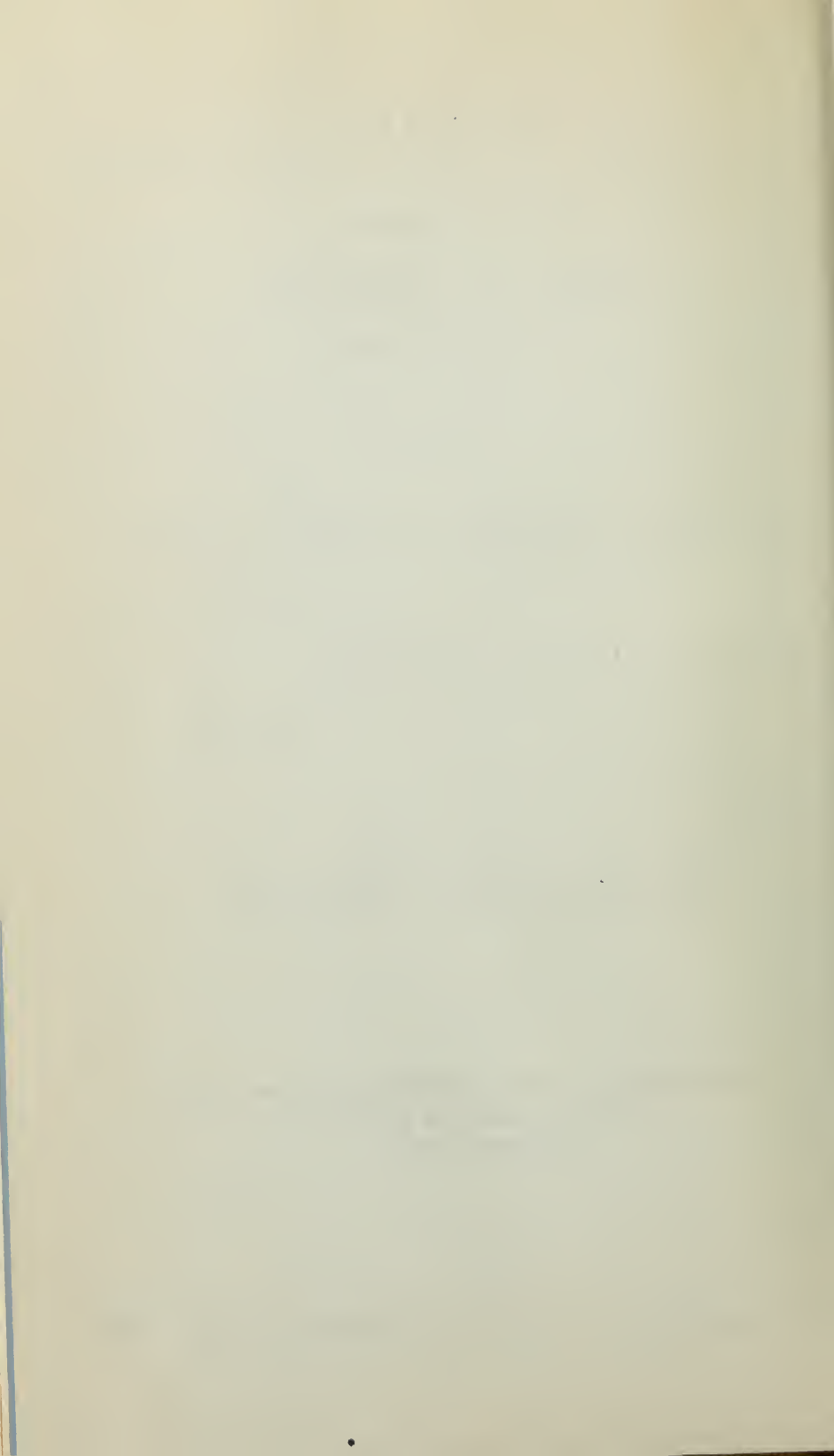
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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Howard, Henry W.

—direct 86

—cross 90

Rooney, Francis L.

—direct 53, 62

—cross 63

—redirect 73

Watts, Wendell

—direct 75

—cross 84

NAMES AND ADDRESSES OF ATTORNEYS

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San Francisco, California,

Attorneys for Plaintiffs and Appel-
lants.

TAX DIV., DEPT. OF JUSTICE,

Washington, D. C.;

U. S. ATTORNEY,

422 Post Office Bldg.,

San Francisco, California,

Attorneys for Defendant and Appellee.

In the United States District Court for the
Northern District of California, Northern Di-
vision

No. 7819

FRANCIS L. ROONEY and IRENE ROONEY,
His Wife,

Plaintiffs,

vs.

UNITED STATES OF AMERICA,

Defendant.

COMPLAINT UNDER THE INTERNAL
REVENUE CODE

Plaintiffs above named complain of Defendant,
and for a cause of action allege as follows:

I.

This action is brought under Section 7422 of the
United States Internal Revenue Code of 1954, and
Section 1346 (a) of Title 28, USCA, as amended,
and it is a claim against the defendant for recovery
of federal income taxes assessed against and col-
lected from plaintiffs pursuant to said United
States Internal Revenue Code.

II.

The plaintiffs, Francis L. Rooney and Irene
Rooney, were at all times mentioned herein, and
now are, husband and wife, and are citizens of the
United States of America, residing in the County
of Sacramento, State of California.

III.

The income tax returns of plaintiffs involved in this proceeding are for the calendar years 1952, 1953 and 1954.

IV.

On or about the 18th day of October, 1956, the District Director of Internal Revenue at Sacramento, California, proposed deficiencies in income tax of the plaintiffs for the years involved here as follows:

Year 1952	\$ 1,966.26
Year 1953	19,700.28
Year 1954	886.48
	<hr/>
Total	\$22,553.02
	<hr/> <hr/>

V.

On November 20, 1956, plaintiffs paid to the District Director of Internal Revenue at San Francisco, California, the deficiencies in federal income tax proposed for the years 1952 to 1954, inclusive, as hereinabove set forth, together with statutory interest thereon to the date of payment.

VI.

On January 28, 1957, plaintiffs, in accordance with the provisions of Section 7422 (a) of the Internal Revenue Code of 1954 filed Claims for Refund of the amounts paid to the District Director of Internal Revenue at San Francisco, referred to in the immediately preceding paragraph of this Complaint, to which said Claim for Refund was at-

tached a statement setting forth the basis upon which the plaintiffs contend the same is due them. Copies of Claims for Refund aforesaid are attached to this Complaint as Exhibit A.

VII.

Under date of June 9, 1958, the District Director of Internal Revenue at San Francisco, California, addressed to the taxpayers by Registered Mail, in accordance with the provisions of Section 6532 (a) (1) of the Internal Revenue Code, his Notice of Disallowance in full of the Claims for Refund hereinabove referred to. Copies of said Notices of Disallowance are attached hereto as Exhibits B-1, B-2 and B-3.

VIII.

That for the reasons set forth in statements attached to said Claims for Refund, attached hereto as Exhibit A, said taxes were illegally and erroneously collected from the Plaintiffs and ought, accordingly, to be refunded to them by the Defendant, together with interest thereon as provided by law.

IX.

That by reason of the aforesaid there is now due and owing to the Plaintiffs herein the sum of \$22,553.02, plus interest thereon from the date of payment alleged in Paragraph V of this Complaint, as provided by law.

Wherefore, Plaintiffs pray judgment in their favor in the sum of \$22,553.02, together with in-

terest thereon as provided by law, for their costs of suit, and for such other and further relief as this Court may deem proper in the circumstances.

HOWARD & PRIM,

By /s/ HENRY W. HOWARD,
Attorneys for Plaintiff.

EXHIBIT A

U. S. Treasury Department
Internal Revenue Service

CLAIM

To Be Filed With the District Director Where
Assessment Was Made or Tax Paid

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

Refund of Taxes Illegally, Erroneously, or Excessively Collected.

Name of taxpayer or purchaser of stamps: Francis L. Rooney and Irene Rooney, his wife.

Number and street: c/o Henry W. Howard, Attorney at Law, 111 Sutter St., San Francisco 4, Calif.

1. District in which return (if any) was filed: Sacramento, California.

2. Name and address shown on return, if different from above: 633-46th Street, Sacramento, California.

3. Period From January 1, 1952, to December 31, 1952.

4. Kind of tax: Income Tax.

5. Amount of assessment: \$1,966.26.

Date of payment: March 15, 1953.

6. Date stamps were purchased from the Government:

7. Amount to be refunded: \$1,966.26.

8. Amount to be abated (not applicable to income, estate, or gift taxes):

9. The claimant believes that this claim should be allowed for the following reasons: See statement attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed

Dated, 19....

Instructions

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, both husband and wife must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

U. S. Treasury Department
Internal Revenue Service

CLAIM

To Be Filed With the District Director Where
Assessment Was Made or Tax Paid

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

Refund of Taxes Illegally, Erroneously, or Excessively Collected.

Name of taxpayer or purchaser of stamps: Francis L. Rooney and Irene Rooney, his wife.

Number and street: c/o Henry W. Howard, Attorney at Law, 111 Sutter St., San Francisco 4, Calif.

1. District in which return (if any) was filed: Sacramento, California.

2. Name and address shown on return, if different from above: 633-46th Street, Sacramento, California.

3. Period From January 1, 1953, to December 31, 1953.

4. Kind of tax: Income Tax.

5. Amount of assessment: \$19,700.28.

Date of payment: March 15, 1954.

6. Date stamps were purchased from the Government:

7. Amount to be refunded: \$19,700.28.
8. Amount to be abated (not applicable to income, estate, or gift taxes:
9. The claimant believes that this claim should be allowed for the following reasons: See Statement Attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed

.....

Dated....., 19....

Instructions

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.
2. If a joint income tax return was filed for the year for which this claim is filed, both husband and wife must sign this claim even though only one had income.
3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.
4. If a return is filed by an individual and a refund claim is thereafter filed by a legal repre-

sentative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

U. S. Treasury Department
Internal Revenue Service

CLAIM

To Be Filed With the District Director Where
Assessment Was Made or Tax Paid

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

Refund of Taxes Illegally, Erroneously, or Excessively Collected.

12 Francis L. Rooney, et al., vs.

Name of taxpayer or purchaser of stamps: Francis L. Rooney and Irene Rooney, his wife.

Number and street: c/o Henry W. Howard, Attorney at Law, 111 Sutter St., San Francisco 4, Calif.

1. District in which return (if any) was filed: Sacramento, California.

2. Name and address shown on return, if different from above: 633-46th Street, Sacramento, California.

3. Period—From January 1, 1954, to December 31, 1954.

4. Kind of tax: Income Tax.

5. Amount of assessment: \$886.48.

Dates of payment: March 15, 1955.

6. Date stamps were purchased from the Government:

7. Amount to be refunded: \$886.48.

8. Amount to be abated (not applicable to income, estate, or gift taxes):

9. The claimant believes that this claim should be allowed for the following reasons: See Statement Attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the

best of my knowledge and belief is true and correct.

Signed

.....

Dated....., 19....

Instructions

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, both husband and wife must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same

fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

Statement Made in Claims for Refund

The taxpayers sustained a net operating loss from farming operations for the short fiscal period January 1, 1954, to July 31, 1954. In accordance with Section 122 of the Internal Revenue Code of 1939, taxpayers carried back said operating loss to the years 1952 and 1953, and claimed a refund on payments made upon Declarations of Estimated Tax for the year 1954. On audit of the tentative carryback adjustment claims filed with respect to said years, the Commissioner reallocated the operating loss in question in substantial part to a successor corporation known as F. L. Rooney, Inc., upon the alleged authority of Section 45 of the Internal Revenue Code of 1939. The deficiencies in income tax resulting from said reallocation of expense, together with statutory interest, were paid by the taxpayers to the District Director of Internal Revenue at Sacramento, California, on November 28, 1956. Said amounts, exclusive of interest, are as follows:

Year	Deficiency in Tax
1952	\$ 1,966.26
1953	19,700.28
1954	886.48
	<hr/>
Total	\$22,553.02
	<hr/> <hr/>

The taxpayers contend that Section 45 of the Internal Revenue Code of 1939 has no application to the facts of this case, and that accordingly the Commissioner of Internal Revenue was without authority to reallocate income and expense between the taxpayers and F. L. Rooney, Inc., for the fiscal periods in question.

EXHIBIT B-1

U. S. Treasury Department
 Internal Revenue Service
 District Director
 San Francisco 2, Calif.

June 9, 1958.

In reply refer to: Code 1110—FL.-227.

Francis L. & Irene Rooney,
 c/o Henry W. Howard, Attorney at Law,
 111 Sutter St.,
 San Francisco, Calif.

Amount Claimed: \$886.48
 Period: 1954

In accordance with the provisions of Section 6532(a) (1) of the Internal Revenue Code, this notice of disallowance in full of your claim or claims is hereby given by registered mail.

By Direction of the Commissioner.

Very truly yours,

/s/ JOSEPH M. CULLEN,
District Director.

FL-227

EXHIBIT B-2

U. S. Treasury Department
Internal Revenue Service
District Director
San Francisco 2, Calif.

June 9, 1958.

In reply refer to: Code 1110—FL-227.

Francis L. Rooney & Irene Rooney,
c/o Henry W. Howard, Attorney at Law,
111 Sutter St.,
San Francisco 4, Calif.

Amount Claimed: \$19,700.28

Period: 1953

In accordance with the provisions of Section 6532(a) (1) of the Internal Revenue Code, this notice of disallowance in full of your claim or claims is hereby given by registered mail.

By Direction of the Commissioner.

Very truly yours,

/s/ JOSEPH M. CULLEN,
District Director.

FL-227

EXHIBIT B-3

U. S. Treasury Department
Internal Revenue Service
District Director
San Francisco 2, Calif.

June 9, 1958.

In reply refer to: Code 1110—FL-227.

Francis L. & Irene Rooney,
633 46th St.,
Sacramento, Calif.

Amount Claimed: \$1966.26
Period: 1952

In accordance with the provisions of Section 6532(a) (1) of the Internal Revenue Code, this notice of disallowance in full of your claim or claims is hereby given by registered mail.

By Direction of the Commissioner.

Very truly yours,

/s/ JOSEPH M. CULLEN,
District Director.

FL-227

[Endorsed]: Filed October 17, 1958.

[Title of District Court and Cause.]

ANSWER

Comes Now the defendant, the United States of America, by and through its attorney, Robert H. Schnacke, United States Attorney in and for the Northern District of California, and for answer to plaintiffs' complaint admits, denies, and alleges as follows:

I.

Admits the allegations contained in Paragraph I of the complaint.

II.

Admits the allegations contained in Paragraph II of the complaint.

III.

Admits the allegations contained in Paragraph III of the complaint.

IV.

Admits the allegations contained in Paragraph IV of the complaint and alleges that plaintiffs were assessed the taxes therein on January 15, 1957.

V.

Admits the allegations contained in Paragraph V of the complaint except alleges that plaintiffs' payment to the District Director was made on November 30, 1956.

VI.

Admits the allegations in the first sentence of Paragraph VI of the complaint; admits that what

purport to be plaintiffs' claims for refund are attached to the complaint, but denies that plaintiffs have a right to recover under any of the reasons in said claims for refund, and denies any and all substantive statements contained in said claims for refund unless specifically admitted herein.

VII.

Admits the allegations in Paragraph VII of the complaint.

VIII.

Denies the allegations contained in Paragraph VIII of the complaint.

IX.

Denies the allegations contained in Paragraph IX of the complaint.

Wherefore defendant demands dismissal of plaintiffs' complaint, judgment in its favor, the costs of this action, and any other relief this Court may deem just and proper.

ROBERT H. SCHNACKE,
United States Attorney;

By /s/ LYNN J. GILLARD,
Assistant U. S. Attorney.

Affidavit of service by mail attached.

[Endorsed]: Filed January 5, 1959.

[Title of District Court and Cause.]

CORRECTED MEMORANDUM
AND ORDER

Plaintiffs have brought this action to recover money paid to defendant as the result of a Federal income tax assessment, which plaintiffs contend was erroneously levied against them. Jurisdiction is founded upon Title 26 U.S.C. § 7422, I.R.C. (1954) § 7422, and Title 28 U.S.C. § 1346. The case has been tried by the Court, sitting without a jury. The relevant facts are simple and are not in substantial dispute.

Plaintiffs are hop farmers. They raised crops and sold them at a profit in 1952 and 1953. They raised a good crop in 1954. They transferred this latter crop, together with the other assets of their farm, to F. L. Rooney, Inc., as of July 31, 1954, in exchange for all the stock of that corporation. Plaintiffs reported the expenses of raising the crop, up until July 31, 1954, on their return as individuals. They did not report the stock of the wholly owned corporation as being of any value. They thus claimed a loss for 1954, and carried it back to 1952 and 1953, in their returns as individuals. They reported the gross profit from sale of the crop as income to the corporation, without reporting any of the expenses of raising the crop prior to July 31, 1954. The District Director of Internal Revenue, in order to reflect clearly the income of plaintiffs and the corpo-

ration, reallocated the expenses of growing the crop to the corporation (I.R.C. (1939) § 45).

The transfer as of July 31, 1954, was not an incident requiring or justifying the realization of gain, or loss, for Federal income tax purposes under the provisions of the law in force at that time (I.R.C. (1939) § 112(b)(5)). It is plaintiffs' contention that their return was justified by this fact, and that the Director had no authority to invoke § 45 of the 1939 Internal Revenue Code in such a way as to nullify § 112 of that Code.

In order to handle the transfer of property in question in such a way as to recognize neither gain nor loss from the transfer, as required by § 112, *supra*, plaintiffs should have transferred the property at a cost valuation. The method which plaintiffs actually chose recognized a loss; and, moreover, it recognized a loss that did not, in reality, exist. The action of the Director under § 45, therefore, effectuated the purpose of § 112, rather than nullifying this latter section. To have been technically correct, plaintiffs should have reported the costs of growing the crop as their expenses, and reported the gross income from the sale of the crop by setting the value of the stock of the corporation equal to the cost basis of the assets transferred in exchange for the stock. If plaintiffs had followed this procedure, the tax result would have been the same as that obtained by reason of the action which was taken by the District Director. Plaintiffs would have reported neither a net gain, nor a net loss,

from their growing and disposition of the crop. The corporation could have offset the cost of growing the crop against the profit derived from its sale.

The Director's action did not nullify or tend to nullify § 112, *supra*. Actually it achieved a matching of income and expenses incurred to earn that income. It, therefore, was well calculated to achieve the purpose of § 45, *supra*, to reflect clearly the income of plaintiffs (See: *United States vs. Lynch*, 192 F. 2d 718). The action of the Director was not in excess of his authority.

This case is closely parallel to *Central Cuba Sugar Co. vs. Commissioner*, 198 F. 2d 214, in which the taxpayer transferred all its assets to a successor corporation after the expenses of raising a sugar crop had been incurred, and just before the crop was to be harvested. The Commissioner was held to have the power (and to have exercised it properly) to allocate the expenses to the successor corporation, although there was no tax avoidance motive for the transfer, and the timing was purely fortuitous. Because the taxpayer and successor corporation were controlled by the same interests, the crop had been transferred at a zero valuation. In an arms length transaction, the crop would have been treated as having some value, to offset the expense of raising it. The situation was held to be one in which the only proper course was allocation under the terms of § 45, *supra*.

The instant case, like *Central Cuba Sugar Co. vs. Commissioner*, *supra*, is clearly distinguishable from

Simon J. Murphy Co. vs. Commissioner, 231 F. 2d 639. In this latter case, one corporation transferred its assets to its sole shareholder on January 11, 1950. It had accrued taxes as operating expenses on January 1st of that year, as was proper under then existing law (*Magruder vs. Supplee*, 316 U.S. 394). This expense was offset by but eleven days of income. Reallocation was declared to be not permissible, as the tax result under *Magruder vs. Supplee*, *supra*, would have been no different in an arms length transaction between independent corporations. The case of *Central Cuba Sugar Co. vs. Commissioner*, *supra*, was properly distinguished upon the ground that there the tax result of an arms length transaction would have been different. In the instant case, as in *Central Cuba Sugar Co. vs. Commissioner*, *supra*, the tax result brought about by an arms length transaction would obviously have been different from, and incompatible with, the tax result urged by plaintiffs. Mr. Rooney frankly testified to what was obvious, namely, that he would never have transferred the crop at a zero valuation to an independent firm or individual.

The case of *Diamond A. Cattle Co. vs. Commissioner*, 233 F. 2d 739, is not in point either, for it did not involve allocation of expenses under § 45, *supra*. Moreover, the taxpayer valued the cattle in that case by an accrual method. A fixed sum was accrued each year "as a cost of raising each critter." As the taxpayer accrued the costs of raising the cattle, "and in so accounting accrued and reported

large amounts of income not received, representing to some extent at least, the increase and growth of the animals in its herds prior to the sale of those particular animals," his situation was entirely different from that of the plaintiffs' in the instant case.

It Is, Therefore, Ordered that plaintiffs take nothing by this action, and that judgment in this case be, and it is, hereby entered in favor of defendant;

And It Is Further Ordered that defendant prepare findings of fact and conclusions of law, a form of judgment, and all other documents necessary for the complete disposition of this case in accordance with the provisions of this memorandum and order, and lodge such documents with the Clerk of this Court pursuant to the applicable rules and statutes.

Dated and Filed as of October 4, 1960.

/s/ SHERRILL HALBERT,
United States District Judge.

[Endorsed]: Filed October 4, 1960, Nunc Pro Tunc.

[Title of District Court and Cause.]

FINDINGS OF FACT AND
CONCLUSIONS OF LAW

This cause came on regularly for trial on April 13, 1960, before the Court sitting without a jury, the Honorable Sherrill Halbert, United States Dis-

trict Judge, presiding. The plaintiff appeared by his attorneys Howard and Prim of 111 Sutter Street, San Francisco, California, and the defendant appeared by its attorneys Laurence E. Dayton, United States Attorney for the Northern District of California, and Thomas E. Smail, Jr., Assistant United States Attorney for said District.

Oral and documentary evidence was introduced by and on behalf of both parties and briefs were filed and the Court, being fully advised, made its Memorandum and Order on October 4, 1960, ordering judgment for the defendant and ordering the defendant to prepare the following:

Findings of Fact

(1) Plaintiffs are husband and wife and citizens of the United States residing in the County of Sacramento, State of California, and are on the accrual basis of accounting for federal income tax purposes.

(2) Defendant admitted plaintiffs' allegation that \$22,553.02 was paid to the District Director of Internal Revenue for deficiencies in federal income tax proposed for the years 1952, 1953 and 1954, together with statutory interest thereon to the date of payment. However plaintiffs did not offer evidence as to the amount of interest paid.

(3) At trial plaintiffs did not establish the amount of income, deductions or taxes paid for the taxable years in question for themselves individually

or their corporation. No individual or corporate income tax returns were offered in evidence for any years from which a recomputation of tax could be made. However, no recomputation of tax is called for because plaintiffs have not shown that the District Director acted arbitrarily, capriciously, or erroneously, moreover plaintiffs have not shown that they overpaid their federal income tax for the years in question.

(4) On January 28, 1957, plaintiffs filed a claim for refund for the taxable years 1952, 1953 and 1954, based on the following allegations:

The taxpayers sustained a net operating loss from farming operations for the short fiscal period January 1, 1954, to July 31, 1954. In accordance with Section 122 of the Internal Revenue Code of 1939, taxpayers carried back said operating loss to the years 1952 and 1953, and claimed a refund on payments made upon Declarations of Estimated Tax for the year 1954. On audit of the tentative carryback adjustment claims filed with respect to said years, the Commissioner reallocated the operating loss in question in substantial part to a successor corporation known as F. L. Rooney, Inc., upon the alleged authority of Section 45 of the Internal Revenue Code of 1939. The deficiencies in income tax resulting from said reallocation of expense, together with statutory interest, were paid by the taxpayers to the District Director of Internal Revenue at Sacramento, California, on November 28, 1956. Said amounts, exclusive of interest, are as follows:

Year	Deficiency in Tax
1952	\$ 1,966.26
1953	19,700.28
1954	886.48
	<hr/>
Total	\$22,553.02

The taxpayers contend that Section 45 of the Internal Revenue Code of 1939 has no application to the facts of this case, and that accordingly the Commissioner of Internal Revenue was without authority to reallocate income and expense between the taxpayers and F. L. Rooney, Inc., for the fiscal periods in question.

(5) Each of the plaintiffs' claims for refund was denied in full by the District Director of Internal Revenue by registered mail on June 9, 1958. This is a suit for the refund of the income taxes alleged to have been illegally and erroneously collected from the plaintiffs for the taxable years 1952, 1953 and 1954.

(6) Plaintiffs are hop farmers. They raised crops and sold them at a profit in 1952 and 1953. They raised a profitable crop in 1954.

(7) Plaintiffs transferred their 1954 crop, together with other farm assets, to their wholly-owned corporation known as F. L. Rooney, Inc., as of July 31, 1954, in exchange for all of the stock of that corporation. The corporation did not pay plaintiffs anything other than its stock, for the

valuable 1954 crop and other farm assets transferred to it.

(8) Plaintiffs deducted all of the expenses of raising the 1954 crop, up until July 31, 1954, on their individual tax return without including any income from the crop or other farm assets transferred to their corporation. Plaintiffs had their wholly-owned corporation report all of the income from the sale of the 1954 crop without deducting any of the expenses of raising the crop prior to July 31, 1954. The 1954 crop was harvested between mid-August and the first of September, 1954.

(9) As a result of deducting the expenses of the 1954 crop on their individual return and not including any income from the sale of this crop on their individual return, plaintiffs claimed a substantial net operating loss and carried it back to the years 1952 and 1953. It is this claimed loss from the profitable 1954 crop which gives rise to plaintiffs' claim for refund and this suit.

(10) The District Director of Internal Revenue, in order to reflect clearly the income of plaintiffs and their corporation, reallocated the income and expenses of the crop between the plaintiffs and their corporation. Plaintiffs did not establish just what the reallocation was that they are attacking but it is apparent that it was an equating of income and expenses which would have been reported if plaintiffs had dealt with their wholly-owned corporation as they would have with a stranger corporation which they did not control.

(11) Plaintiff admitted, and it is a fact, that he would not have transferred the valuable crop and other assets to F. L. Rooney, Inc., without any consideration if he did not control the corporation to which they were transferred.

(12) In order to clearly reflect the income of plaintiffs and their wholly-owned corporation, it was necessary for the District Director of Internal Revenue to allocate gross income and deductions between plaintiffs individually and their wholly-owned corporation.

(13) The operation of plaintiffs' farm as a sole proprietorship and the subsequent operation of the farm by their wholly-owned corporation constituted two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests.

Conclusions of Law

1. The Court has jurisdiction of the parties and this action pursuant to 26 U.S.C., 1346(a).

2. Plaintiffs' transfer of their 1954 crop and farm assets to F. L. Rooney, Inc., qualified as a transfer under § 351 of the Internal Revenue Code of 1954.

3. The District Director of Internal Revenue's action in allocating income and deductions between plaintiffs and their wholly-owned corporation was a proper and reasonable exercise of the discretion granted under Section 482 of the Internal Revenue

Code of 1954 in order to reflect clearly the income of plaintiffs and their corporation.

4. When Section 482 is applicable it necessarily overrides Section 351 of the Internal Revenue Code of 1954.

5. Plaintiffs failed to sustain their burden of proof.

6. Plaintiffs' claims for refund were properly denied by the District Director of Internal Revenue and plaintiffs should take nothing by this action.

7. Plaintiffs' complaint should be dismissed with prejudice and the defendant awarded allowable costs.

8. Judgment should be entered for defendant.

Dated: November 14, 1960.

/s/ SHERRILL HALBERT,

United States District Judge.

Certificate of mailing attached.

Lodged November 7, 1960.

[Endorsed]: Filed November 14, 1960.

In the United States District Court for the Northern
District of California, Northern Division

Civil No. 7819

FRANCIS L. ROONEY and IRENE ROONEY,
His Wife,

Plaintiffs,

vs.

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

By reason of the law, the pleadings, and the Findings of Fact and Conclusions of Law heretofore filed in this cause,

It Is Hereby Ordered, Adjudged and Decreed that plaintiff take nothing by his complaint, and that the complaint and this action be dismissed with prejudice and judgment be entered for defendant, and

It Is Further Ordered, Adjudged and Decreed that the defendant have and recover from the plaintiff its allowable costs of suit in the amount of \$..... to be taxed by the Clerk of this Court and paid forthwith by the plaintiffs.

Dated: November 14, 1960.

/s/ SHERRILL HALBERT,
United States District Judge.

Lodged November 7, 1960.

[Endorsed]: Filed November 14, 1960.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Francis L. Rooney and Irene Rooney, his wife, plaintiffs above named, hereby appeal to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on November 14, 1960.

Dated: January 4, 1961.

/s/ HENRY W. HOWARD,
Attorney for Appellants, Francis L. Rooney and
Irene Rooney.

[Endorsed]: Filed January 6, 1961.

In the District Court of the United States for the
Northern District of California, Northern
Division

No. 7819

FRANCIS L. ROONEY and IRENE ROONEY,
His Wife,

Plaintiffs,

vs.

UNITED STATES OF AMERICA,

Defendant.

Hon. Sherrill Halbert, Judge.

REPORTER'S TRANSCRIPT

Wednesday, April 13, 1960.

Appearances:

For the Plaintiffs:

N. RICHARD SMITH, ESQ.,
HOWARD & PRIM.

For the Defendant:

THOMAS E. SMAIL, JR., ESQ.,
Assistant U. S. Attorney.

April 13, 1960—10:00 o'Clock A.M.

The Clerk: Case No. 7819, Rooney vs. U. S.,
Trial by the Court.

Will counsel please state their appearances for
the record?

Mr. Smith: N. Richard Smith, appearing for
the Plaintiff.

Mr. Smail: Tom Smail appearing for the De-
fendant.

Your Honor, I would like to introduce Mr. Smith
to you from San Francisco, who is a partner—
I guess he is not a partner, but of the firm of the
office of Henry Howard, also an attorney from
San Francisco.

Mr. Smith: Mr. Howard, your Honor, is Coun-
sel for the Plaintiff in this matter, and because he
is going to be a witness I will conduct the examina-
tion.

The Court: Very well. Gentlemen, I have looked
over the memos that have been filed in this matter
here, and I do not conceive that there is very much
dispute about the facts in this case, is there?

Mr. Smith: I think perhaps with one or two
minor corrections that is correct, your Honor.

The Plaintiff takes the position, your Honor, in
this case, that the motives of the taxpayer which
gave rise to the transaction of the moneys which

were to be allocated and so forth are of some importance in—— [2*]

The Court: Even so, all you can do is to testify as to what those intents were. You haven't got any machine that will register red when your intents are right and black when they are wrong.

Mr. Smith: That is correct. I don't know if your Honor——

The Court: Well, I have read over the statements that you made in here and I don't understand that there is any contest; that you are going to contend that certain things were done in good faith, and there is a presumption of law that people act in good faith, but there is also a burden of proof, on your side of the case.

Mr. Smith: Yes, your Honor. The plaintiff is certainly willing to stipulate that the facts are as outlined in the memorandums, if such stipulation would be acceptable to the United States Attorney.

The Court: What I would suggest in that regard is, would you be willing to stipulate that the testimony that you would offer would develop that, as distinguished—I don't know that the Government would be willing to stipulate that those were in truth the facts. They would simply be willing to stipulate that if you called witnesses they would testify in that manner.

Mr. Smith: That is correct, your Honor.

Plaintiff intends to call three witnesses: The Plaintiff, Mr. Rooney; his accountant, Mr. Watts, and his Counsel, Mr. Howard. [3]

***Page numbering appearing at top of page of original Reporter's Transcript of Record.**

The Court: Well, any way you want to do it is all right with me. I was just suggesting it be handled in the most expeditious manner, because as I see it, this is mostly a question of law in this case.

Mr. Smail: I believe that is so. I don't know whether I should so stipulate or not. I am considering it seriously. First of all we take the position that the taxpayer's motives don't make very much difference. If he is a wonderful person or a terrible person, as to what the Commissioner did, that doesn't affect it too much.

The Court: I understand that is your position.

Mr. Smail: And secondly, I believe that the taxpayer admits that they were thinking of saving some taxes here. There is nothing wrong with that. The Government doesn't say that people can't use a little good common sense to avoid some taxes.

The Court: The Supreme Court has held in so many words that every citizen has the right not to evade taxes, but to avoid taxes.

Mr. Smail: The Government cannot take the position that you can't use the full letter of the law and its spirit to avoid all the taxes you can. It certainly would throw a lot of people out of business if that were the case. All of us this week are faced with filing our own taxes and we know we [4] do the best we can to pay as little as we have to. We are not taking the position certainly that there is anything improper in that.

I do have one apology, I believe, to the Court. In my opening memorandum, if I might state, I think there may be a jurisdictional question here

that I have not adequately set forth. It may be that the scope of the trial before your Honor is more narrow than I realized when I wrote this memorandum, and it may be at this time I should take and talk on that, with your Honor's permission and Counsel's permission.

The Court: Do you mean talking in terms of jurisdiction?

Mr. Smail: Yes, your Honor.

The Court: Well, we better resolve that right now, because that is fundamental with this Court.

Mr. Smail: I think it will only take me a moment to do it.

The Court: Very well.

Mr. Smail: These tax refund suits, of course, the key and the fundamental underlying thing is the claim for refund. That is the thing we found the action on. The claim for refund of taxes asserted to be erroneously collected is with the Commissioner, and if he denies it then this Court has jurisdiction or if six months passes, and he doesn't do anything about it this Court has jurisdiction to re-examine that determination and determine whether the Commissioner was right or wrong.

But the claim for refund is the only basis that the [5] Commissioner had to act upon, and in turn the only basis that the Court has to examine the Commissioner's action to see if he acted right or wrong.

If I might digress briefly, I think this is a very well drafted complaint by the taxpayer. So often they are full of a lot of irrelevant matter, and this

is a very clean one. The pleadings, paragraph 6 of the Complaint, indicate that the claim was filed and it sets for the basis upon which the Plaintiff contends in this action, and attaches it, and then paragraph 8 of the Complaint, the taxpayer said that for reasons set forth in the statement attached to the claim, which is attached, the basis for contending that the determination by the Commissioner was erroneous.

Of course, that is a proper and only basis for filing a Complaint.

Our answer merely, in paragraph 6—we admit practically everything, and in paragraph 6 we deny that they had a right to recover for the reasons set forth in the claim, and paragraph 8 we deny it is erroneous.

So clearly the question before the Court then is, was the Commissioner right or wrong in disallowing the claim for refund for the reasons set forth in the claim, both by pleadings and by the law generally.

If we look at the statement attached to the claim it is more now than the issue as the Government framed it in its [6] pretrial memorandum. That statement is confined to the question of whether the Commissioner had authority at all to reallocate. The last paragraph, I believe, is the critical one. I have been talking pretty fast about these documents, your Honor.

The Court: I have it here.

Mr. Smail: You have that claim before you?

The Court: Yes.

Mr. Smail: Thank you.

In the last paragraph there the taxpayer—it says, “The taxpayers contend that Section 45 of the Internal Revenue Code has no application to the facts of this case, and that accordingly the Commissioner of Internal Revenue was without authority to reallocate income and expense between the corporation and the individual.”

That is quite a different question, I believe, than considering, as I set forth in my memorandum, assuming it was an attack on the discretion of the Commissioner to decide whether he had any authority to do this at all.

It is comparable, I suppose, to whether if this case should go up on appeal and your Honor should hold the Commissioner is right, that the taxpayer should contend on appeal first that the Court might have been wrong in making its legal conclusions or findings of fact, and secondly that they just didn't have any authority to consider the action at all. [7]

As I read this claim for refund it is the position taken by the taxpayer that the Commissioner was, and I quote here, without authority to reallocate.

I came upon this fairly late last night, and in reviewing the file and reviewing their brief I noticed that there are contentions in the brief, such as would indicate that the Commissioner didn't have authority to perform the acts he did, either because Mr. Rooney was an individual or—there is one other basic reason pointing out where they contend that there was no authority to act.

Consequently it is my interpretation of this case as it is before this Court both on the pleadings and on the necessarily jurisdictional requirements to review the Commissioner's action, his discretion in allocating this income is not before the Court, but only the question of whether he had authority at all to act under the Section.

I do now recall their other position. Their position was that one of the provisions of the Internal Revenue Code, a very old one, now Section 351 of the '54 code, which used to be one twelve three five of the '39 code, says that an individual or any other entity can transfer assets to a corporation and if immediately thereafter they are in control of that corporation that there is no tax recognized on that transfer.

Now there is no question, that is a basic provision of the [8] Code. You can transfer anything you want to of your own corporation and you are not going to be taxed on the gain. And they take the position in their brief that this section under which the Commissioner acted is just simply inconsistent with that. We are trying to reallocate the income between the individual and the corporation, and as I understand the position, section 651 says there is no tax recognized, well, this just simply goes out the window, the Commissioner is trying to do something he can't do.

As I understand it, maybe that was their position earlier and they would like to change it—maybe it is all my fault in framing the issue as to whether the Commissioner acted arbitrarily and

capriciously or unreasonably, in my own framing of the issues heretofore, that rightly or wrongly it seems to me that the Court at this time does not have jurisdiction to consider that question, but only the question of whether the Commissioner had any authority at all.

I have not attempted to make an opening statement on the facts, but bring this question to your Honor's attention at this time, and to opposing counsel. If I have misled either the Court or opposing Counsel in framing the issue in the brief I filed last week I am sorry for that, but in digging right down into the pleadings to see what that issue was, and the claim for refund, I believe it is both necessary and proper for me to call it to the Court's attention at this time. [9]

The Court: What do you say about that, Mr. Smith?

Mr. Smith: I am unable to see any substantive distinction between the question of whether or not the Commissioner was without authority to employ his weapon of Section 482, or whether he exercised a Section that was improper if, in fact, he exercised it in an improper fashion and it was not properly applicable to the case, that is, to the facts of this case, it seems to me he was without authority to employ it. If I properly understand the difference which Mr. Smail outlined, there is a material difference between the two questions. The reason whether or not the practical result achieved by the application of Section 482 is one which is

proper on the facts of this case, whether or not the issue is framed in the language——

The Court: Mr. Smith, let me pose this problem to you: Do you say there is no distinction between the authority of a man to arrest you and his right to arrest you?

Mr. Smith: Well, I am thinking in terms of the practical results or consequences of that arrest.

The Court: Well, that is what I am worried about, is the practical results. The policeman that comes down the street here certainly has the authority to arrest me if I violate the law.

Mr. Smith: That is correct.

The Court: But he doesn't have the right to arrest me [10] until such time as I do something which by law I am not authorized to do.

Mr. Smith: That is correct, your Honor, assuming he exercises his authority in a fashion that is improper, that is, under circumstances where he does not have the right, and I have a civil remedy for being arrested as a consequence of this breach of authority, which is the same thing from a practical standpoint that this taxpayer is doing, that is, filing his application for refund on the basis that the Commissioner was either without authority to apply this section or that he applied it in a fashion that was unreasonable, capricious or arbitrary.

The Court: Well, let's put this thing on another situation. We have got a question of search and seizure, illegal search and seizure. Is it your position that if a person makes an illegal search, that is, a search made without authority, even though——

Mr. Smith: That is, made without right, your Honor, even though with purported authority?

The Court: Well, I am trying to distinguish between these two words, "Right" and "Authority." In other words, I am a police officer. I make the search and seizure. If I had a search warrant there wouldn't be any question about it, my search would be perfectly legal.

Mr. Smith: Assuming the warrant was [11] valid.

The Court: Yes, a valid search warrant. But I have no search warrant, and I think because of certain other phases—for instance I am making this search in connection with an arrest, and one of the more recent situations is where you arrest a tenant, as to whether or not you have the right to search the landlord's house, and I think I have that right, and I go ahead and search the house.

Is there a distinction between my authority to do that and my right to do that?

Mr. Smith: Well, I would assume, your Honor, that—frankly that is a facet in which I am not well versed.

The Court: Well, I realize we are dealing in semantics here.

Mr. Smith: My offhand reaction would be—

The Court: We are really doing some work on the high bars.

Mr. Smith: Yes, a double somersault, I would say.

Authority is a standard which when applied seems to be given purported ability to carry out

the act in question. The ultimate determination of the right to do that, I would say that the authority is a prima facie standard, whereas the ultimate fact or the ultimate decision rests upon the question of right.

Now the Commissioner in this circumstance is the investigative officer who conducts the search, has exercised what appears to be authority. He has met the standard, and he [12] alleges that what he has done in this case was to more clearly reflect income.

We are now faced in this Court, as I view it, with the question of determining whether or not the Commissioner had the right to exercise such authority. And it seems to me this is what we were talking about when we say he is without authority or he has exercised it improperly.

The Court: Mr. Smail, what have you got to say about it?

Mr. Smail: The words "right" and "authority" I think I would be willing to give either one. I think the arguments in their brief about this section being necessarily inconsistent with some other section which they proceeded under, and which the Government admits they proceeded under, your Honor, and it was proper to proceed, there was nothing wrong with their use of Section 351 by itself, really does not quite strike home. The purport of both of those arguments is that the Commissioner is without right or authority. In other words, he just can't come in here and do it at all. It is not

that he used bad judgment or was capricious or unreasonable in doing it.

That is inside the bounds of the right or authority to do something. Whether you do it well, or whether you do it poorly——

The Court: Is not that like the officer who makes the arrest of the tenant, and therefore honestly believes that he has the right to search the entire house of the landlord? [13]

Mr. Smail: I think it is. I think it is also similar to the somewhat offhanded analogy I made when speaking to your Honor first, that if this very matter should go up on appeal and a tack was taken that this Court had no right or authority to consider the matter, that is an entirely different question from saying that the facts were clearly erroneous or the legal conclusion was wrong. To say that somebody doesn't have any right or authority to do something means they just can't do anything, right or wrong. They just can't even make a stab at it.

The Court: Well, it is just like saying that the search was made by a citizen.

Mr. Smail: That is right.

The Court: It has no color of authority at all.

Mr. Smail: I believe that is a proper analogy, particularly where we get into the position where a police officer could make an arrest under suspicion and a citizen could not. And if he came in and it was said he had no authority and we put him on the stand and establish that he was a police officer and he had suspicion, then I think it would be

their burden to go forward. That would really end the case. He would have authority, and then we would determine whether the search was proper.

The Court: Well, I think I have this problem in mind here at the present time, but I think that this case is of [14] sufficient brevity that there will be no occasion to stop right now and say, "We are going to decide this point." Why can't we get the whole thing before me? I take it that you raise that issue now——

Mr. Smail: I do.

The Court: And will so contend throughout this case.

Mr. Smail: I do.

The Court: That this case is limited by these words, "Was without authority to reallocate the income and expenses between the taxpayer," and so forth.

Mr. Smail: Right, sir, and I make it on two grounds, both the pleadings and the basic law in this area as to how we should view this, what was presented to the Commissioner and I also agree, your Honor, that we should go ahead with the trial. Although I am in Sacramento occasionally and these gentlemen are both from San Francisco and their client is here, and I don't believe the trial would take long, and I think that it might be an inconvenience for them to have to come back again.

The Court: Is that agreeable, Mr. Smith?

Mr. Smith: Yes, your Honor.

The Court: In other words, unless you are going to be prejudiced by this situation——

Mr. Smith: No.

The Court: —that would be the way I would suggest doing. [15]

Mr. Smith: I might say that in view of the objection which Mr. Smail has presented, it will be the intention of the Plaintiff throughout the testimony to demonstrate that the Commissioner was without authority in the sense that the exercise of his authority was improper under the circumstances of this case, if such a decision exists. In other words, reaffirming our position that there is no substantive distinction between the two.

The Court: All right, let us proceed.

Mr. Smith: I might also at this time, your Honor, apologize to the Court for several errors which appear in the memorandum which was filed by the Plaintiff. I think that—

The Court: Well, don't worry about it, Mr. Smith, because I might just as well tell you right now that I am going to require you to file written memorandums in support of your respective positions in this matter and you can correct the whole thing, and get it in sharp focus at that time.

Mr. Smith: All right, your Honor. Fine.

If your Honor please, this is a suit for recovery of overpayment of income taxes paid by the Plaintiff with respect to the year 1954.

The action was filed pursuant to the provisions of Section 6532 of the Internal Revenue Code of 1954.

The controversy arises out of the following facts, which [20] I will briefly summarize:

Mr. Rooney, during the year 1954 and for many years prior thereto was engaged in the business of farming a crop on leased land in Sacramento County. He carried on his business as a sole proprietor.

In 1954, as he is today, he was a married man. At that time he had two adult sons, one of whom was serving in the army in Korea, the other was a part-time employee in the family business, and also was a part time college student.

The income tax returns of the Plaintiff and his wife for the years involved in this proceeding were prepared by Mr. Wendell Watts, a Certified Public Accountant here in Sacramento, whom the Plaintiff intends to call as a witness.

As the evidence will show, early in the spring of 1954, Mr. Rooney had occasion to consult with Mr. Watts with respect to the preparation of his income tax returns for 1953. At that time, due to the fact that his Federal Income Taxes paid for the year 1953 exceeded the sum of \$32,000 he had a discussion with Mr. Watts with respect to effecting some reduction in his Federal Income Tax liability.

Secondly, he was interested at that time in passing some present interest in his business to his two sons.

With these objectives in mind he suggested the possibility of the formation of a partnership.

Mr. Watts, as his testimony will show, suggested that a [21] corporation would perhaps be a more appropriate entity under the circumstances, and to reaffirm that judgment and to implement such a

program, it was decided upon Mr. Watts' suggestion to consult Mr. Henry Howard, who was a tax attorney in San Francisco.

As a consequence of that suggestion a joint meeting between Messrs. Watts, Howard and Rooney was held at some time in the spring of 1954, toward the end of April, according to the files of the Plaintiff's Counsel.

At that meeting there was a full consideration of all the range of Federal income and State tax problems.

Mr. Smail: I think it might be appropriate for me to interrupt and say that I will stipulate to everything opposing counsel has said so far as the background testimony, and I will agree just the words that are in the record are true, if we can save any time.

Mr. Smith: Fine, your Honor. We are perfectly willing. I don't wish to waste the Court's time.

The Court: All right.

Mr. Smith: As a consequence of these discussions it was decided to form a corporation. Plaintiff, as the testimony will show, at the time he consulted with his advisors was in no wise aware of the fact that the formation of a corporation or the selection of an effective date for the transfer of the assets of his business to the corporation would result in the [22] opportunity to avail himself of the provisions of 122 of the Internal Revenue Code of 1939 relating to the carry-back of a net operating loss. That possibility was first discovered by his

accountant, Mr. Watts, in July of 1954, and the decision was made without the knowledge of Mr. Rooney and it, in no sense, was a motivating factor in his consultations or in his decisions with respect to the transfer which was subsequently effected.

It has been stipulated by the parties as to the date of incorporation of F. L. Rooney, Inc., the successor corporation, as to the date on which the assets of the sole proprietorship was transferred to that corporation, to wit, July 31, 1954, in exchange for all the stock of the corporation.

Consequently, upon the discovery that a net operating loss would be available, a claim for refund was filed, and a refund was paid thereon in the amount of approximately \$22,000.

Subsequent to that the Internal Revenue Service, under the purported authority of Section 482, re-allocated the expenses incurred by Mr. Rooney, operating as a sole proprietor, to the corporation, thus establishing a deficiency in the income taxes.

I think your Honor is aware of the meaning of the literal language of Section 485 and of its successor, 482.

The issue in this case is, of course, whether the taxpayer has the right to the refund which arose out of the net operating [23] loss generated by the transfer to the corporation of the assets of the sole proprietorship on this mid-year date, and whether or not the express release provisions of that section can be thwarted by the exercise by the Commis-

sioner of the alleged authority conferred on him by Section 482.

I might say in summation, your Honor, that so far as the Ninth Circuit is concerned this is a case of first impression. It appears to the taxpayer to be an issue of some real substance and merit. It was first considered, I think, in essentially this form by the Tax Court in the Central Cuba Sugar Case, where the holding was favorable to the taxpayer.

That case, of course, went to the Second Circuit, where the tax court was reversed, and since then there have been two other Circuit Court of Appeals decisions which we think have real pertinence in the action, and which we will comment upon at a later point.

(Discussion between Mr. Smail and Mr. Smith, inaudible to reporter.)

Mr. Smail: May the record show that Counsel and I will stipulate that Mr. Rooney as an individual during the year 1954 was on an accrual basis of accounting.

I have no particular difference with Counsel's statement of facts, but I believe I wrote down three brief things. One was the date the assets were transferred to the corporation. We were rather careful to stipulate that was a transfer as of a [24] certain date. We are not agreeing that those assets were in fact transferred.

Secondly, although I just don't know about their consideration or awareness of these tax advantages

of this transfer, I am aware of the very good reputation of Mr. Henry Howard as a tax attorney and the C.P.A., Mr. Watts. It seems a little strange to me, but I don't think it really makes any difference whether they were aware of it or not, whether they considered it or not, doesn't make too much difference. I believe the only question we are considering is the jurisdictional question of whether——

The Court: How about the presumption in the law that everyone is presumed to know the law? That is a violent presumption, but I think it is a presumption that we have to indulge in once in a while.

Mr. Smail: Well, as I say, my presumption, my personal presumption would go a little farther. I know the good reputation of Mr. Henry Howard as a tax attorney. It seems strange to me, but I don't think it is a matter of importance. We are not reviewing the taxpayer's intent or that of his agents or attorneys.

It is quite proper that people do set up corporations to make moves to save substantial taxes. Those are proper motives.

In this action since both businesses were controlled by the same individual, Congress has given the Commissioner [25] discretion to allocate that income if it does not accurately reflect annual accounting concepts on the books of those businesses. He has exercised that discretion, and that is what we are reviewing, if we can go that far. I don't wish to state again the earlier proceedings about the more limited——

The Court: I understand you are not waiving that at any stage of this proceeding?

Mr. Smail: Right, sir.

The reason for this section is a very basic premise of our Federal Income Tax in this Country, namely, it is on an annual accounting basis, and whether it is easy or difficult, each year we have to figure out taxes, and we have to pay taxes each year. It is a difficult thing to operate and we need money every year, and that is the way we try to do it.

This section is only pointed at an individual or corporation which controls two businesses to transfer assets or some other activity in an attempt to distort that annual accounting concept and, as in this case, make a substantial profit look like a loss for that year and a loss the year before, and a year back, where three years' taxes were recovered although there was in fact a substantial profit, because, and only because of the control of the two businesses a loss was able to be reported here. The Commissioner said that "That does not accurately reflect income," and exercised his power. [26]

The only other comment about the Court of Appeals of the Ninth Circuit, I believe they have before it for review under Section 41, only three sections away or four sections away from Section 45, where it is said that you must attribute income to the corporation or individual, this is *U. S. vs. Lynch*, which was relied upon in part by the Court of Appeals of the Second Circuit in *Central Cuba Sugar*, and is almost dead on point here and the leading case in this area.

Again this is approaching a legal discussion, which I think should be reserved.

I have no further opening statement, your Honor.

The Court: All right, you may proceed.

Mr. Smith: We will call as our first witness, your Honor, Mr. Francis Rooney.

FRANCIS L. ROONEY

one of the Plaintiffs herein, called for the Plaintiffs, sworn.

The Clerk: Your name?

The Witness: Francis L. Rooney.

Mr. Smith: To expedite the proceeding, your Honor, I was just trying to go through the proposed direct examination of Mr. Rooney to see if we can get some factual issues upon which there appears to be some dispute.

The Court: Well, that is what I wish you would do, even if you have to take a little time to orient yourself, because [27] there is no use of my sitting here and hearing testimony on matters on which there is no dispute.

Mr. Smith: If Counsel has no objection, perhaps we could recess——

Mr. Smail: You seem to have your testimony all typed up.

Mr. Smith: Yes, and if Counsel has no objection to the procedure, if I might employ leading questions until such point as he finds it objectionable, we could perhaps move through the background stuff very rapidly and get to the critical questions.

(Testimony of Francis L. Rooney.)

The Court: Very well.

Mr. Smail: From just a brief glance it appears that quite a bit of this is immaterial and may be——

The Court: Do you want to take a couple of minutes to go over this, take a little recess and go over this and get oriented?

Mr. Smail: It might be a good idea.

The Court: I would like you to do your threshing before you get in here. I like to have the grain in here.

Mr. Smail: Yes, sir.

Mr. Smith: That will be fine, your Honor, if you give us five minutes.

The Court: We will take a brief recess at this time and let me know as soon as you are ready to proceed.

(Recess.)

Mr. Smith: Counsel for the Government, your Honor, has reviewed the format of the direct examination, including the [28] questions and answers, which would have been followed were Mr. Rooney examined.

We have agreed, with your Honor's permission, that we will just submit this to the Clerk for the record, if that is permissible.

Mr. Smail: The Government so stipulates, your Honor.

The Court: All right, let it be received and marked Plaintiff's Exhibit 1.

(Testimony of Francis L. Rooney.)

Mr. Smail: It may be that I would like to cover one or two of these items on cross-examination.

The Court: That is perfectly all right.

Mr. Smail: I do agree this would be his testimony if he testified in regular fashion.

(The format of the direct examination of Francis L. Rooney was marked Plaintiff's Exhibit No. 1.)

PLAINTIFFS' EXHIBIT No. 1

Ques.: Please state for the record your name, address and your occupation.

Ans.: I am Francis L Rooney of and I am in the business of raising hops.

Ques.: How long have you been engaged in this business of raising hops?

Ans.:

Ques.: Did you operate your business as a sole proprietor prior to 1954?

Ans.: Yes.

Ques.: During those years was your business generally profitable?

Ans.: Yes.

Ques.: Had there been any marked increase in your taxable income from farming operations during the few years immediately preceding 1954?

Ans.: Yes (explain).

Ques.: Prior to 1954 you had who, if anyone, had

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

assisted and advised you in connection with your income tax returns?

Ans.: My accountant, Mr. Wendell Watts.

Ques.: Did you have occasion to talk with Mr. Watts some time during the spring of 1954?

Ans.: Yes, I did.

Ques.: What was the subject of that conversation?

Ans.: It had occurred to me that instead of realizing all of the income from my farming between myself and Mrs. Rooney, it would be advisable to give my two grown sons some interest in the business. What I hoped to do was to reduce my own personal income taxes, as well as to give the boys some income from the farm that would be taxable to them and to make them feel as though they were a definite part of our family business.

Ques.: Did you have any specific suggestion to discuss with Mr. Watts with respect to accomplishing the objectives which you just outlined?

Ans.: Yes, I thought perhaps we could form a partnership.

Ques.: What did Mr. Watts advise you?

Ans.: He suggested that I consult with Mr. Henry Howard, a tax attorney, in San Francisco.

Ques.: Did you then meet with Mr. Howard and Mr. Watts during the spring of 1954?

Ans.: Yes.

Ques.: What did they suggest?

Ans.: Mr. Howard explained to me that forming

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

a partnership would not be feasible as the assets of my business were for the most part leaseholds and a couple of undivided interests in real property. He explained that it would be very difficult to transfer a partial interest in those to my sons. He also mentioned that one of my sons was in the Army in Korea and the other only worked part-time on the farm while going to college, that the Government might not recognize this as a valid partnership for tax purposes. To solve my problem, he seemed to suggest that we form a corporation.

Ques.: Did Mr. Howard make any additional suggestions to you as to what might be accomplished through the organization of a corporation?

Ans.: Substantial reduction in income tax liability due to lower corporate rates. He mentioned that giving this stock would reduce the amount of federal estate taxes which would have to be paid on my death.

Ques.: To the best of your recollection, Mr. Rooney, did either Mr. Howard or Mr. Watts mention to you during these preliminary discussions the possibility that the organization of a corporation would result in your having substantial expenses incurred in 1954 which would not be offset by any income?

Ans.: To the best of my recollection there was no mention of anything of this nature by either of them.

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

Ques.: Were at that time aware of the meaning of the term "net operating loss"?

Ans.: No.

Ques.: Did you then decide to proceed with the formation of a corporation?

Ans.: Yes.

Ques.: Now, Mr. Rooney, let's turn just for a moment to some of the fundamentals of the hop raising business. Would you describe for us, generally speaking, the periods in any calendar year in which expenses are incurred and in which income is earned?

Ans.: (Give a brief description of your expenses, including the fact that planting and cultivation expenses are always incurred during the early part of the year and the only expenses in the Fall are in connection with the harvest—then point out the approximate time during which the crop is harvested and the fact that that is the point in time at which income is received.)

Ques.: Now the parties have stipulated that the crop of hops which were sold in the Fall of 1954 and which gave rise to the income which the Commissioner has reallocated in this case was sold by you to S. S. Steiner, Inc., on January 22, 1954. Would you give us a brief description of how those contracts are made?

Ans.: (Give here just a summary of the way you normally deal with S. S. Steiner, including that

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

you may sell one, two or more years of crops at any time and that the price is fixed.)

Ques.: Is the purchaser, Mr. Rooney, required to pay the price which is set in the contract, regardless of the condition of the crop?

Ans.: Not by any means. The crop has to meet a number of exacting standards.

Ques.: Would you describe those standards for us?

Ans.: (Give here, or mention here what the normal requirements are, including moisture content, delivery dates, etc.)

Ques.: If these standards are not met, is the purchaser obligated to take the crop at any price?

Ans.: No. He has the right to reject it entirely, or sometimes we might renegotiate a lower price.

Ques.: Then, is the income to be realized from the sale of any given crop not certain until the size and quality of the crop is determined?

Ans.: Yes. That's correct.

Ques.: Let's return then to the formation of this corporation. It has always also been stipulated by the parties that F. L. Rooney, Inc., was had its Articles accepted for filing on May 27, 1954. What is your recollection, if any, of what Mr. Howard may have told you with regard to the length of time it would take to get the corporation organized and the assets of your business transferred to it?

Ans.: Mr. Howard didn't give me any specific period. As I recall, he told me that it would take

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

several months to get the Articles filed and to get a permit to issue stock from the Corporation Department.

Ques.: It has also been stipulated that the transfer of the assets of your business to F. L. Rooney, Inc., your corporation, occurred as of July 31, 1954, and that the corporation gave in exchange all of its issued stock. Did you, Mr. Rooney, make the decision as to the effective date for the transfer of your assets to the corporation and for the closing of the books of your sole proprietorship?

Ans.: No. I assumed that it would be effective as soon as Mr. Howard could get the job done.

Ques.: Who made that decision?

Ans.: Mr. Howard and Mr. Watts.

Ques.: Was that date of transfer discussed with you before July 31, 1954?

Ans.: No. I left it to Mr. Howard and Mr. Watts.

Ques.: Were you later informed of the results of selecting that date?

Ans.: Yes.

Ques.: What is your recollection as to when and by whom that matter was discussed with you?

Ans.: I know that it was in the early Fall that either Mr. Watts or Mr. Howard, probably Mr. Watts, told me about this operating loss because I told them that if they got the refund for me I would buy them both of them season tickets to the 49ers football games.

Ques.: Did this net operating loss influence you

(Testimony of Francis L. Rooney.)

Plaintiffs' Exhibit No. 1—(Continued)

in any way or at any time with regard to whether the corporation should be formed or when it should actually acquire your assets?

Ans.: Never.

Ques.: Now, Mr. Rooney, you indicated earlier that it was your intention at the time this corporation was formed to give some interest in it to your two sons. Is that correct?

Ans.: Yes.

Ques.: Has that ever been done?

Ans.: No.

Ques.: Why?

Ans.: (Can you explain this?)

Ques.: Now, Mr. Rooney, going back to your statement with regard to the expenses of raising a crop, as I recall the only expenditures in the Fall are connected with the harvest. Is that correct?

Ans.: Yes.

Ques.: Is F. L. Rooney, Inc., on a fiscal year?

Ans.: Yes.

Ques.: When is that fiscal period?

Ans.: Aug. 1 to July 31.

Received in evidence April 13, 1960.

(Testimony of Francis L. Rooney.)

Direct Examination

By Mr. Smith:

Q. Mr. Rooney, to put this in context, in connection with the discussion of the income and expenses which are incurred or realized in the production of any particular hop crop, I should like to ask you if, for example, you decided that you would raise your last crop of hops in the year 1961, is it correct that the entire income of the corporation for that fiscal year would be earned after July 31 of 1961? A. That is correct.

Q. What expenses, Mr. Rooney, would the corporation have [29] during the fiscal year beginning August 1 of 1961 and running to July 31 of 1962, assuming that your last crop was in the fall, what expenses would you have?

A. The crop in '61, the only expense would be the harvesting and the shipping expenses.

Q. There will be no expenses during that fiscal year incurred in Planting and growing the crop?

A. No.

Q. Would this then be, as a practical matter, the opposite case to the year 1954, in which you had expenses in the period January 1 to July 31 with no income because of the harvest date falling after July 31 of that year?

Mr. Smail: I object to that question, your Honor, because the entrance of the sole proprietorship in 1954 changes the matter substantially.

(Testimony of Francis L. Rooney.)

The Court: Sustained. I think it is a matter that can be resolved by simple analysis anyway.

Mr. Smith: That is the only reason for the question, your Honor. I think it is self-explanatory on an analysis of the facts previously introduced in the record. We have no further questions.

The Court: All right, Mr. Smail.

Cross-Examination

By Mr. Smail:

Q. Mr. Rooney, some of the testimony that Counsel and I have already stipulated to that you, in effect, [30] have already given, it is stated that you had two reasons for wanting to form a partnership or corporation in 1954, one was to save some taxes, and the other was to bring your sons into the business? A. That is right.

Q. Have you brought your sons into the business?

A. Well, I have them working with me, and I intend to give them stock in the corporation.

Q. Have you done so, sir, as of 1960?

A. No; I haven't.

Q. You and your wife own all the stock in the corporation? A. That is right.

Q. And you and your wife are the sole owners of your ranch business as a sole proprietorship prior to the time of the formation of the corporation?

A. Well, I operate on leased land, but I am the sole owner of the business, my wife and myself.

(Testimony of Francis L. Rooney.)

Q. Thank you, sir.

A. I was operating on leased land at that time. At the present time I own land.

Q. Aside from the question of the two businesses, that is, the proprietorship and the corporation in 1954, if we just threw them all into one pot, is it fair to say that a substantial profit was made on the 1954 crop?

Mr. Smith: I object to that question, your Honor, as [31] calling for a conclusion of the witness.

Mr. Smail: I think it is fair to see whether the '54 crop made money or lost it. I think that would be a fact for the Court to consider.

The Court: You have to have more foundation for it. What do you mean by the '54 crop?

Mr. Smail: Well, yes, maybe I should ask some more questions. It is summed up in that opening testimony.

Q. Was your business, sir, prior to the formation of the corporation, that of a hop rancher?

A. Yes.

Q. Was that the business of the corporation when formed, or when it came into operation?

A. Was it operating?

Q. No; was raising hops the business of the corporation after it was formed? A. Yes.

Q. And I believe your testimony that has already been stipulated to was that in the years prior to 1954, particularly in '53, you made quite a bit of money on the 1953 crop? A. Yes.

(Testimony of Francis L. Rooney.)

Q. My question is, although the issue before this Court, or one of the questions is whether we should be allocating expenses and between the proprietorship and the corporation, if you didn't look at those entities and looked to see how much money either you or the corporation spent to raise the crop [32] and how much you got, if the crop was successful to either you or the corporation. In other words, did you make a profit, was the hops crop a profitable thing, if we can just put aside these other questions in issue for a moment?

A. I am a little hard of hearing. I didn't get all that question.

Q. It was too long. This is what I want to find out, Mr. Rooney: You have already testified by stipulation that the '53 crop was quite profitable. In other words, you got more money out of the hops crop than you put into it?

A. That is right.

Q. Is that the same case in 1954, if you just consider how much money went into the crop whether it was corporation or individual, and how much money you got out of it? Was it a profitable crop?

A. It was.

Q. Thank you. Did you get any money from the corporation when you transferred your farming assets and crop to them?

A. Did I get anything from——

Q. Yes, any money? A. No.

Q. Did you get any other property that had a substantial fair market value in lieu of money?

(Testimony of Francis L. Rooney.)

A. I got stock in the corporation.

Q. You didn't declare that as income on your return, though, did you, the receipt of that stock, the value of it, if any?

A. Well, I would say you would have to ask my income tax man on that. [33]

Q. Well, the corporation had no——

Mr. Smith: We will stipulate the corporation had no assets.

A. The corporation had no assets.

Q. (By Mr. Smail): Your attorney has stipulated to that. That is right, the corporation had no assets other than those you were transferring to it, is that correct? A. That is right.

Q. I assume you wouldn't have transferred that quite valuable crop and assets to a corporation unless you controlled it, would you, sir, without receiving any money for it?

A. That is right.

Q. I would like to find out just when these assets were, in fact, transferred, Mr. Rooney. Maybe you can tell us what the assets were that were transferred, first?

A. Well, the assets at that time were appraised and they were appraised at quite a high price. My assets vary with the price of hops. My assets, when hops are good they are worth money, when they are cheap they are not worth anything. At the time that the corporation was formed I think it was appraised at about \$196,000.

Q. Did you transfer any equipment?

(Testimony of Francis L. Rooney.)

A. That was the whole thing, equipment and leases and money in the bank and everything that——

Q. Did you transfer the hops themselves, or the trellises? [34] A. Yes.

Q. Mr. Rooney, I have been in town only a brief time, but I have been scurrying around the Recorder's office and various places, and I can find no notation of transfer either under real property, under the Tax Assessor's office, of the trellises or the hops, all the things are still listed in your name, except the real property, which you leased, and I find no change of title. Can you explain that to me?

A. No; I can't explain that to you. It was never brought to my attention.

Q. Was it brought to your attention that it was in fact transferred? The only notation I find is in assignment from you to the corporation for the following year of the crop mortgage approved by Mr. Steiner of Steiner, Incorporated, which was under contract to buy the crops, that being an agreement dated February 16, 1955, which was recorded on March 28, 1955. Was anything else actually transferred of record? Any other assets?

A. Well, as far as I was concerned, I thought the whole works had been transferred from my ownership to the corporation. Now I didn't realize that it hadn't been recorded. In fact, I thought when they formed the corporation that took care of everything.

Q. Just the forming of the corporation itself

(Testimony of Francis L. Rooney.)

would have taken your assets and put them in the corporation, is that what you mean? [35]

A. Yes.

Q. What about when you received the notice of the tax assessment from the County office here on those hops and trellises which are still in your name, didn't it seem strange to you, that it should be in the corporation's name, that the corporation owns them?

A. As far as the hops, I never had any hops for the Tax Collector——

Q. What about the trellises, though?

A. Well, they have been assessed against me right along.

Q. You, individually?

A. Well, I would have to look at those tax bills, but I thought they were coming to F. L. Rooney, Incorporated. I could be wrong. But as far as I can remember they come to F. L. Rooney, Incorporated. Now, I would have to check on that to be sure.

Q. What about the transfer which is of record of the writing or contract with Steiner, Incorporated, which was not recorded until March 28, 1955? That is a year after this tax year. What is your recollection about that?

A. Well, I don't record those contracts. They record those themselves.

Q. Who do you mean by "themselves"?

A. The Steiner Company. I have nothing to do with recording those. I notify them——

Q. If I might interrupt you, I may have been

(Testimony of Francis L. Rooney.)

misleading. What [36] I am talking about was the assignment of the right under the Steiner contract from you to your corporation, Rooney, Incorporated. This is what was recorded.

That was only approved by Steiner because they had some interest in the crop. Now that wasn't recorded until the following year.

A. Well, as I say, I notified them that we were changing from private ownership to corporation and as far as when they recorded it, I couldn't say. As I say, I have nothing to do with the recording of the contract.

Q. Mr. Rooney, this agreement was dated February 18, 1955. It wasn't recorded until a month later, but there was no agreement until February 16, 1955, on the books of the recorder, even though it wasn't recorded until March 28th, the agreement itself is dated in that year.

A. Well, I couldn't give you exact dates on that. The Steiner Company has a local representative right in Sacramento here, and he knows every move I make. I talk to them two or three times a week. They knew I was incorporating, and as far as when those papers were recorded I wouldn't know, because I notified them that I was incorporating and they knew it, and as far as when they recorded those papers I wouldn't know anything about it.

Q. Well, what about the time—it is your complete testimony that it is your understanding that just when that corporation [37] was formed, which

(Testimony of Francis L. Rooney.)

was in May, I guess, in 1954, that that automatically transferred your farming assets?

Don't you have any recollection of signing bills of sale or something you mentioned earlier, a transfer of leases and these other documents?

A. Well, the leases—there was a notation made on the lease that the corporation was taking over the lease that had been in my own personal name.

Q. You didn't record that, though? Did you just make a pencil notation on the copy of your lease, is that what it is?

A. No; we had some papers drawn up in the lawyer's office that I would be responsible for the assets—I would personally be responsible for the payment of rents and the assets of the F. L. Rooney Corporation.

Mr. Smith: Your Honor, if I may, I would like to make objection to the materiality of this testimony, in view of the stipulation by the parties as to the formation of the Corporation and as to the fact that the transfer of the assets was effected as of July 31, 1955.

Mr. Smail: As of—as of—it is important, though, when those assets weren't transferred until the next year. It sure does change this case.

The Court: That is what I understood Mr. Smail to state, that he was unwilling to stipulate that they were in fact [38] transferred, but they were transferred as of that date.

Mr. Smail: I am willing to stipulate what the books show.

(Testimony of Francis L. Rooney.)

Q. Mr. Rooney, if the agreement between you and the corporation transferring your right to sell the hops to Steiner, Incorporated, was dated February 16, 1955, would it be your recollection that your attorneys or whoever handled this got around to transferring your other assets about that time?

A. Well, now, to be honest with you I have no idea on that, because I thought when these corporation papers were drawn up that automatically everything would go on record that I had formed the corporation and that the assets, as far as I was concerned, they were all changed to the corporation. Now, as far as being a matter of record, I thought that was all taken care of. I didn't know. It was a legal matter and I know that I had to sign papers that I would personally be responsible for any debts of the corporation, and I signed papers with the Steiner Company that I would still be held responsible for the delivery of the hops and so forth by the corporation.

Q. You know that the corporation wasn't even given power to issue stock by the State of California until toward the end of August, 1954, August 24th or something like that?

A. Well, I know—as far as I was concerned, my fiscal year was to begin on August 1st, and when I got all those records [39] back from the Corporation Commissioner, why, then, I was—I understood I could issue stock any time.

Mr. Smail: I believe there is a stipulation to the contrary, your Honor.

(Testimony of Francis L. Rooney.)

Mr. Smith: Pardon, counsel? I am sorry.

Mr. Smail: There is a stipulation that the State of California authorized the issuance—first authorized the issuance of stock on August 24th, isn't it?

Mr. Smith: Yes.

Mr. Smail: ———1954.

Mr. Smith: The terms of that permit, Counsel, will show that the issuance of stock was authorized as of July 31st.

Mr. Smail: Yes.

Q. Mr. Rooney, do you have any documents or bills of sale, or transfers or assignments of leases or anything in court with you today that show when these assets were, in fact, transferred, if ever?

A. I have no papers with me today, no.

Q. Do you have any recollection of signing over any bills of sale of either equipment or the hops or the trellises here in issue?

A. Well, as I told you before, I was forming a corporation, and all the assets were transferred to the corporation.

Q. How was that? How did that happen?

A. Well, I have a book with all the corporation in it, and it [40] shows when the assets were changed.

Q. I know that. It has got a date on there, July 31, as of that date? A. Yes.

Q. It says, "As of." A. Yes.

Q. What we want to know is when those assets were really transferred. That is a little early, even

(Testimony of Francis L. Rooney.)

before you could issue stock in exchange for the assets, almost two months afterwards.

A. I don't want to get confused on these dates.

Q. Please believe me, sir, I am not trying to confuse you. I am only trying to establish when those assets were, in fact, transferred?

A. Well, in fact if you asked me, I would say when the corporation was approved by the State Corporation Commissioner. I would say that is when the transfer was made, because they were all assigned to the corporation.

Q. Is there some document that assigned them?

A. Pardon me?

Q. Is there some document that assigns these assets?

A. Well, there was a list—no, there was just a list of the assets that were incorporated in there, and the papers were drawn up and they were in the corporation, as far as I was concerned. [41]

Q. Even though there was no official transfer from you to the corporation? A. Yes.

Mr. Smail: No further questions, your Honor.

Redirect Examination

By Mr. Smith:

Q. Just two brief questions, Mr. Rooney: Had any income been realized by the sole proprietorship prior to July 31 of 1954?

A. No income whatever.

Q. Did the sole proprietorship as operated by

(Testimony of Francis L. Rooney.)

yourself actually pay all of the expenses incurred prior to July 31 of 1954? A. Yes.

The Court: What do you mean by the sole proprietorship?

Mr. Smith: I meant the business as operated by Mr. Rooney individually, your Honor.

The Court: It was my understanding that he and Mrs. Rooney owned it. There was some community property somewhere in here that somebody was talking about.

Mr. Smith: Yes. I think your Honor is correct. I should rephrase that and state that the business was operated by Mr. Rooney individually with the co-ownership of his wife.

The Court: This is community property?

Mr. Smith: Yes.

The Court: Of Mr. and Mrs. Rooney?

Mr. Smith: Yes, that is right. [42]

The Court: That is why I questioned the word "solely."

Mr. Smith: Yes. Your Honor is correct.

Mr. Smail: I would like in open court to avoid—well, I think I will withdraw that suggestion.

The Court: Is this all for Mr. Rooney then?

Mr. Smith: That is all.

The Court: That is all, Mr. Rooney, thank you.

Mr. Smith: Call Mr. Wendell Watts.

WENDELL WATTS

called as a witness for Plaintiffs, Sworn.

The Clerk: Your name?

The Witness: Wendell Watts.

Direct Examination

By Mr. Smith:

Q. Will you state, for the record, Mr. Watts, your occupation?

A. Certified Public Accountant.

Q. What is the name of your firm?

A. Watts, Thompson & Company.

Q. How many years have you been qualified as a Certified Public Accountant.

Mr. Smail: I will stipulate Mr. Watts is a C.P.A. and is well qualified.

Mr. Smith: Fine.

Q. I have one question in that connection, Mr. Watts: Could the income of this corporation earned during the period August [43] 1, 1954, to July 31, 1955, under any theory of accounting have been attributed to F. L. Rooney individually, or to Mr. and Mrs. Rooney?

A. No; it was a corporation from that time.

Q. Under no theory of accounting could it have been attributed to Mr. Rooney on an accrual theory or cash basis theory?

A. No; it could not.

Q. Now you were consulted by Mr. Rooney in the spring of 1954?

A. That is right.

Q. Would you relate to us—as you observed this morning, there is some divergence between the Government and the taxpayer—the substance of those

(Testimony of Wendell Watts.)

conversations, that is, the making of decisions with respect—

Mr. Smail: I can't hear you.

Mr. Smith: What I am trying to do, counsel, is to summarize and just get to the one point with respect to the net operating loss.

Q. Would you describe for us how that possibility arose?

A. Well, as I remember—I will have to stipulate it is from memory—of course, some time after the filing period, presumably in April or May, Mr. Rooney came to me with the idea of in some way diverting part of his income to his two sons who recently were out of college and had become active in the business, and suggested forming a partnership with them. I, [44] as I usually do, discouraged partnership for various reasons, of liability and unwieldiness of partnerships, and suggested that we have a conference with Henry Howard, who I have used as Tax Attorney for a number of years.

We did have such a meeting in my office, and I do not know the date, and I looked through my file and can't find it, but presumably it was early in May some time, and at that time we went over Mr. Rooney's business affairs, his financial affairs, and decided it probably would be a good idea for him to incorporate this business and eventually go into some gift program of stock to his sons.

As I remember, the corporation—Mr. Howard went ahead and formed the corporation, got the

(Testimony of Wendell Watts.)

charter, which was in the latter part of May, May 27th, is that right?

Q. That has been stipulated to?

A. Yes.

The date. Then, of course, the next step was to make a list of the assets and liabilities and so forth of the corporation to be transferred. I made up such a list and at that time—I guess it was at that time that I suddenly realized Mr. Rooney had been operating for seven months or six months with no income. The nature of the hop crop is all the income comes in one period. When I turned over the list of assets and liabilities to be exchanged for stock in the corporation I asked Mr. Howard the feasibility of closing this sole proprietorship and making such transfer as of July 31st and using [45] the expenses for that seven months period to carry back in prior years when Mr. Rooney had rather high income, high income taxes.

Q. Mr. Watts, what was the date, to the best of your recollection, upon which this possibility first occurred?

A. Well, it must have been some time during the middle of July, because—I can't give you the exact date, but when I wrote that letter to Mr. Howard it was in July some time, and that is presumably when I first got the idea.

Mr. Smail: If your Honor please, if we are testifying about a letter, may we have it in evidence?

The Court: Is the letter available?

(Testimony of Wendell Watts.)

Mr. Smith: The letter is in our files, your Honor. We will find it, your Honor.

Q. Will you then proceed, Mr. Watts, what transpired after your letter of July 19th to Mr. Howard with respect to an operating loss?

A. Well, I am still relying on memory that goes back five or six years.

Mr. Smail: Could we have the letter in evidence here?

A. Well, of course, the letter, my memory——

Mr. Smail: I would object to your memory.

Mr. Smith: Counsel, the question now is what transpired after the writing of this letter. The question is what transpired after the date of this letter.

(Mr. Smith produced the letter.) [46]

The Court: The letter dated July 19th from Watts and Gibson to Henry Howard, 111 Sutter Street, San Francisco, will be marked Plaintiff's Exhibit 2.

Mr. Smail: We have no objection to it going in evidence.

(Document referred to was marked Plaintiff's Exhibit No. 2 in evidence.)

PLAINTIFFS' EXHIBIT No. 2

Watts and Gibson
Certified Public Accountants
2115 J Street
Sacramento 16, California

July 19, 1954.

(Testimony of Wendell Watts.)

Wendell E. Watts,
George T. Gibson.
Mr. Henry Howard,
111 Sutter Street,
San Francisco, California.

Dear Henry:

I have just returned from a month's trip back to the deserts of the East and received your letter regarding Frances Rooney. I was positive that I had sent you all the information except the appraisals when I returned the corporation papers, but if I did I can't find my copy. In any case here are the answers that you need:

1-A. F. L. Rooney was borned in Sacramento, July 19, 1894. He attended Sacramento schools, served in the first World War and was an automobile salesman for the Universal Motor Company, Sacramento, from 1919 to 1940. He was an automobile salesman for Ellsworth Harrold Company in Sacramento from 1940 to 1942. Since 1942 he has been a hop grower.

1-B. Wendell E. Watts was borned in Ohio, January 25, 1916. AB degree from Wittenberg College in 1938. Accountant for General Electric Company from 1938 to 1942. FBI agent 1942 to 1946. Public Accountant 1946 until present.

2. Suggested officers: F. L. Rooney, President; Frances L. Rooney, Jr., Vice-president; Bernard

(Testimony of Wendell Watts.)

Rooney, Vice-president; Mrs. Irene G. Rooney, Secretary-Treasurer.

3. The American Trust, Main Office, Sacramento, will act as depository.

4. I have already sent you the appraisals. In addition to the assets listed approximately \$10,000.00 will be taken over by the corporation. There will also be a liability of at least \$24,000.00 for advances on this year's hop crop.

5. The lease runs from September, 1952, until September, 1957. There is no option provision. It is a cash rental lease for bare land. The lease agreement is between the Estate of William J. Sheldon, the lessee, and Frances L. Rooney, the lessor. The lease provides for a yearly cash rent of \$6,282.00 payable semi-annually. If you need further information on this let me know.

It seems to me it would be desirable to turn over the assets to F. L. Rooney, Inc., as of July 31st. A short period return could be made for the corporation from the time of the incorporation until July 31st, and then run the corporation on a fiscal year ending July 31st. By doing this the first seven months' expenses would be on Mr. Rooney's return without any income and the operating loss less his salary for the last five months could be carried back to the 1953 calendar year and some of the tax for that year could be recovered. In addition there would be no tax due for the corporation until Oc-

(Testimony of Wendell Watts.)

tober 15, 1955. Will you please consider this and see if you can see any difficulty in my reasoning?

In regard to the William Stock Farming Company, I would suggest that you send me your bill and I will forward it on. They are very prompt and will take care of this bill as soon as it is received.

Very truly yours,

/s/ WENDELL E. WATTS.

WEW/mdb

Received in evidence April 13, 1960.

Mr. Smail: But, of course, it is not evidence of what is stated in there but merely the evidence that the letter was written and was mailed by Mr. Watts to Mr. Howard. With that understanding it may go in.

Q. (By Mr. Smith): Then it is reflected by the letter, Mr. Watts, that you suggested in this communication that—perhaps I should read it for the record:

“It seems to me it would be desirable to turn over the assets”——

The Court: I don't think that is necessary. It may be considered read into the record and you may use such portions of it as you deem appropriate.

(Testimony of Wendell Watts.)

Mr. Smith: I am merely trying to refresh the recollection of the witness, your Honor.

The Court: Well, let him take a look at it.

(The letter was handed to the witness.)

Mr. Smith: Would you then like to restate the substance of your suggestion to Mr. Howard with respect to the net operating loss? [47]

Mr. Smail: If your Honor please, I think this letter speaks for itself rather than have him testify to what he believes the letter says.

Mr. Smith: Well, fine, Counsel. All I want to do is follow through on this, and determine——

The Court: Let's proceed.

Mr. Smith: ——what response was given then to your letter?

A. Well, Mr. Howard agreed that was probably the thing to do and that is what we did do, as the record shows, did turn over the assets and started operating as a corporation as of August 1st.

Mr. Smail: If I may, I am sorry to interrupt, but the testimony concerning the turning over of the assets is not responsive. It is not quite adequate for this witness to testify that the assets were turned over when there are no documents whatsoever indicating the assets had been turned over.

Mr. Smith: Your Honor, it is my impression that the objection that an answer is not responsive lies in the——

The Court: Well, I am going to let the answer stand, and you may cross-examine.

(Testimony of Wendell Watts.)

Mr. Smail: Thank you, sir.

Q. (By Mr. Smith): Mr. Watts, did you formally close the books of this individual operation by Mr. and Mrs. Rooney on July 31, 1954, or on or about that date? [48]

A. They were closed as of that date, yes.

Q. As of that date. The books of the corporation and of Mr. Rooney, Mr. and Mrs. Rooney individually, reflect completely that the transfer was effected on July 31, 1954, is that correct?

A. That is right.

Q. And the final question, after the decision had been made to effect a transfer on July 31, 1954, but not until after that decision had been made did you then communicate it to Mr. Rooney? If that question was not clear let me put it this way:

After you and Mr. Howard had reached a decision as to the effective date of the transfer, did you have occasion to tell Mr. Rooney about that decision and the results generated by it?

A. Well, I am sure that I didn't tell Mr. Rooney until such time as after I had heard the response from Mr. Howard on the letter that I had written, because I wanted to get a legal opinion on it before I went further with it.

Mr. Smith: Fine. I have no further questions.

(Testimony of Wendell Watts.)

Cross-Examination

By Mr. Smail:

Q. I forgot to ask Mr. Rooney a question; maybe you can help me with it, Mr. Watts: Do you know what time they harvested the hops in 1954, Mr. Rooney?

A. Well, the hops are harvested about the same time every year. They start about August 15th, approximately.

Q. And about what time do they finish? [49]

A. They run for about two weeks before they are harvested and put in the dryer.

Q. Thank you, sir.

The Court: What do you mean, Mr. Watts, hops are harvested the same time every year?

A. Well, it is within a few days, they start harvesting hops the same.

Q. Do you mean Mr. Rooney, or do you mean people generally?

A. I mean the people generally in the Cosumnes Valley and the American River Valley in this particular area, the crop harvest is the same within a few days year after year.

Q. Well, it can run up to a month's difference, can't it? A. Not in this valley.

Q. (By Mr. Smail): Are you Mr. Rooney's— if I may interrupt maybe I can clarify it this way—are you Mr. Rooney's accountant?

A. That is right.

(Testimony of Wendell Watts.)

Q. Then you would have familiarity as to when he was harvesting and paying bills?

A. That is right.

Q. And it is your testimony here that he would have been harvesting his crops from about mid-August, give or take a week, to about the first of September in the year 1954?

A. That is right.

Mr. Smail: Do you think that satisfies, your Honor? I didn't [50] mean to interrupt here, but I thought maybe if we established that he knew Mr. Rooney's operations——

The Court: I am not worried about the record in this matter here, but from my observation of the thing I don't think Mr. Watts is completely correct in saying that it is only a matter of a few days difference each year.

Mr. Smail: But in the year 1954——

The Court: It depends on what a "few days" means.

Q. (By Mr. Smail): In the year 1954 you have some recollection that Mr. Rooney's harvest fell within your description, namely, from about mid-August to about the first of September?

A. I am sure of that.

Q. Thank you, sir. Now, despite your testimony as to the time of the transfer of the assets you testified to on the books of both the proprietorship and the corporation as of July 31, 1954, which is a stipulated fact, do you know of the existence or did you have any documents which might have

(Testimony of Wendell Watts.)

transferred these assets, namely, bills of sale, a transfer of the lease, the hops themselves, the vines?

A. I had nothing to do with that at all.

Mr. Smail: No further questions.

Mr. Smith: No further questions. Call Mr. Henry W. Howard.

(Witness excused.) [51]

HENRY W. HOWARD

called as a witness for Plaintiffs, Sworn.

Mr. Smith: Your Honor, may Mr. Watts be excused?

The Court: Unless there is objection, he may.

Mr. Smith: Any objection, counsel?

Mr. Smail: None at all.

Direct Examination

By Mr. Smith:

Q. Mr. Howard, would you state your address and occupation for the record?

A. My name is Henry W. Howard, I am an attorney at law, practicing at 111 Sutter Street in San Francisco.

Q. You were consulted by Mr. Francis Rooney in the Spring of 1954? A. I was.

Q. Would you relate the substance of your conversations with Mr. Rooney, Mr. Howard?

A. I am going to relate it briefly, because your Honor has heard these facts from other witnesses.

Mr. Rooney and Mr. Watts consulted with me,

(Testimony of Henry W. Howard.)

and at the time of our first conversation Mr. Rooney was in the mind to form a partnership with his sons. I advised him that in my opinion over-all he would be better off if his business were transferred to a corporation.

We computed at the time that the over-all income tax burden would be substantially less under a corporate form of operation than it was as an individual proprietorship at his [52] level of income.

I suggested to him that the corporate form of business would be a more economic method of accumulating surpluses for the purposes—I recall he mentioned at that time the ultimate purchase of land. And I also discussed with Mr. Rooney, we discussed at some length, the distribution of his estate among his children, with the idea of reducing the ultimate impact of death tax.

In that connection I pointed out to him that it would be much more feasible to make that distribution through the means of stock in the operating company than it would be to transfer an undivided interest in the property.

Mr. Rooney concurred in my suggestion, and on the 27th of May the articles of incorporation were filed.

Prior to that time I embarked upon the usual routine of organizing the corporation and transferring the assets to it. As I recall, I wrote Mr. Watts on the 14th of May asking for all the various details relating to the corporation and the transfer of the property, such as an analysis of the assets

(Testimony of Henry W. Howard.)

and their cost, and who were to be the officers and directors and who was to have the bank account and so on.

The reply of Mr. Watts to me is in evidence here. As I recall at the time he was away in the east for more than a month after I wrote him, I think, in the middle of May.

When I had the information I immediately prepared the [53] application for a permit to issue stock, and my recollection is that was filed with the Corporation Commissioner about the end of July. I think it was forwarded to Mr. Rooney for the purposes of signature about that time.

In connection with that application we prepared minutes of the corporation authorizing the filing of the application and acquisition of the assets in exchange for stock. Then I instructed Mr. Watts to memorialize the same on the records of the individual and the corporation.

Q. The decision as to the effective date of the transfer of these assets, Mr. Howard, was one reached between you and Mr. Watts, is that correct?

A. Yes, after Mr. Watts wrote me on the 19th of July, I recall discussing the matter with him on the phone at some length, and I concurred in his suggestion.

Q. Prior to that suggestion you were merely waiting the fulfillment of the normal mechanics of filing the application and getting the necessary supporting documents?

(Testimony of Henry W. Howard.)

A. We were going through the usual routine of making the transfer.

Q. Mr. Howard, in your opinion, would it have been sensible for you to implement Mr. Rooney's program by forming a corporation on May 27th, and then allowing that corporation to remain dormant without any transfer of the assets of the individual business to it until the end of the calendar year [54] 1954?

A. I did not contemplate doing that. I contemplated carrying out the program suggested to him as rapidly as I could.

Q. Now, with respect to the documents of the transfer and the actual transfer of the assets of the individual business to the corporation, would you relate to us what steps were taken to effect that or what your recollection is?

Mr. Smail: If your Honor please, I am going to probably have some objection here if we are talking about documents transferring the assets. I respect Mr. Howard's testimony here and I would like to hear as much of it as I possibly can, but this date of transfer of assets is one of importance, to me, and if it comes right down to getting close on dates I would like to see the documents.

The Court: Perhaps you can cross-examine him on that, Mr. Smail, and ask him what he can produce.

Mr. Smail: All right, sir.

A. I don't have a definite recollection, Mr. Smith, of direct participation in the transfer except

(Testimony of Henry W. Howard.)

the preparation of the corporate documents, the application to the corporation Commissioner set forth specifically the assets to be transferred, the date as of which they were to be transferred and the appraisals required by the Commissioner in that connection. I am familiar with that. I am also familiar with the fact that I believe very shortly thereafter the bank accounts were [55] transferred to the name of the corporation.

I did not participate in the transfer of other assets. I knew there was no real property involved, so we did not have the usual problem of preparing deeds and recording them.

In these situations, I am frank to say, that not very often is the transfer of personal property and equipment of this kind memorialized in assignments or bills of sale unless there are creditors' rights, or something of that nature involved.

Mr. Smith: You may cross-examine.

Cross-Examination

By Mr. Smail:

Q. You gave us a couple of things, you mentioned you were familiar with the appraisal, the list of assets, and the transfer of the bank accounts. The thing I am principally interested in is the transfer of these hops and trellises upon which the hops were located. Do you know about the transfer of those?

A. I have no personal knowledge as to whether or not that was done by any document.

(Testimony of Henry W. Howard.)

Q. What about your knowledge about this list of assets other than the hops or trellises? Maybe you can enlighten both me and the Court about this transfer, if any?

A. Well, as I say, we contemplated the transfer to the corporation of all the operating assets of the sole proprietorship. [56]

Q. Contemplated?

A. Yes, and that was to be done in consideration of stock, so in that connection, in connection with the application for permit to issue stock, as I recall, we furnished the corporation Commissioner with a list of the assets which would be transferred as of July 31st—

Q. That is the proposed transfer, is that correct, the proposed transfer? You furnished that list to the Commissioner?

A. Yes; I think that was—

Q. And then on August 24th the Commissioner said you can issue stock? That is a stipulated fact here, I believe.

A. He issued a permit to issue stock as of that date.

Q. In 1954. And then would it be—

A. As of July 31.

Q. Yes, as of. Would it then be your testimony that these assets were in fact transferred after you received notification that the assets could, in fact, be transferred for stock? I assume you would have to have the stock before you could exchange the stock for the assets?

(Testimony of Henry W. Howard.)

A. Well, the normal practice in California is to transfer the assets upon the receipt of the permit as of the date authorized by the Commissioner. That has created a common problem, as you know, because——

Q. Well, would it be your testimony then that the actual transfer of the assets was necessary after the corporation [57] received permission to issue stock on August 24, 1954?

A. Well, no; I view it as merely a ratification by the corporation Commissioner.

Q. If I might interrupt you, you stated you had no recollection of the actual transfer of these assets. You are really talking about ratification of nothing, aren't you?

A. In the sense that there was no bill of sale to the personal property——

Q. Well, as a lawyer, how do you transfer these assets? A. Well, as I say——

Q. I am mostly interested in these hops and trellises.

The Court: I think you are interrupting Mr. Howard. Let him finish his answers.

A. As a lawyer, I would say that when you instruct your client to close his books and when you file an application on his authority with the Corporation Commissioner to transfer personal property to a corporation, and when the Corporation Commissioner ratifies that transfer that that is sufficient to effect an actual transfer of the property, and I don't know who could complain about it. I

(Testimony of Henry W. Howard.)

don't think as a legal proposition that anything further is required.

Q. Are you through? A. Yes.

Q. But when you are talking about these assets you are talking about assets other than the hops and trellises, which you said [58] you had no recollection of, is that correct?

A. Well, in my own contemplation at the time I viewed them all the same way. In other words, we took a description of all the assets and we went through the motions of transferring them to the corporation. As I recall, and this would be routine, the minutes of the corporation reflect the transfer and reflect the authority in the corporation to receive the transfer and to issue its stock accordingly as of a certain date.

Q. Even though the minutes—excuse me, are you through?

A. And in the normal case the burdens and benefits of ownership are picked up and reflected as of the date set forth in the permit of the Corporation Commissioner.

Q. Are the minutes here? A. No.

Q. Is it your recollection of the minutes, if we may proceed this way, then, that there is nothing in there that actually says there is a transfer, however, when you got the power to issue the stock for the assets?

A. Well, the Corporation Commissioner would require you to furnish a resolution of the Board of Directors authorizing the acquisition of these

(Testimony of Henry W. Howard.)

assets as of a specific date in exchange for stock, at certain values, and so on and so forth.

Q. And the Corporation Commissioner said that was all right on August 24th?

A. That is correct.

Q. And you were notified by mail, then, were you, in a day or [59] two, subsequently?

A. The time in the Corporation Commissioner's office in my experience can be anywhere from three weeks to four or five months.

Q. In other words, you wouldn't have heard about it until September, probably, then?

A. Well, I heard about this—when the permit is mailed I would get it the next day. It bears on its face it was mailed on August 24th, as I recall. I am merely saying that you can't hold up these things until the Corporation Commissioner actually issues a permit, because you would just never get into operation. And the problem that has arisen is not only a practical matter, but it is a problem of Federal Tax Law, because you make a transfer to the Corporation and then you may not get a permit for 60 days, and so on, and then the question arises as to whether there was or was not a tax free exchange as of the date specified for the transfer of the assets.

Q. I am sure you appreciate as a tax attorney that this case couldn't even be before his Honor if those assets were not transferred until that crop was picked, the taxpayer on an accrual basis, he would necessarily have to have all the income at-

(Testimony of Henry W. Howard.)

tributable to him unless those assets were in fact transferred before any harvesting of the crop, and the taxpayer, it is a stipulated fact, is on an accrual basis.

It is a critical factor here to find out how long he owned [60] those assets. As you know, I needn't tell you, as a tax attorney, and his client, that that is a fact here, he didn't in fact transfer those assets until that crop was harvested in that year there would be no point of the Commissioner reallocating income, because it would all be his as a matter of law.

A. Well, of course, this is the first time that the Internal Revenue Service or the Government at any level in this proceeding has questioned the fact, or raised the issue. The income tax returns were filed and accepted on that basis, and——

Q. It may be the first time it has been discussed with you, but it is a very important question here?

A. As a matter of procedure in transferring an operating business, involving essentially personal property, the transaction here was carried out normally and in a way that would normally effect the transfer of assets, in my opinion.

Q. Maybe I can make two concluding questions. In the first place, you have no recollection of transferring either the leasehold or the growing hops, and trellises, which I assume would be real property, and recording that transfer? A. No.

Q. And secondly——

A. I told Mr. Rooney, and discussed with Mr.

(Testimony of Henry W. Howard.)

Watts the manner of informing his landlord and also the Steiner Company with respect to the fact that the business had been transferred to [61] the corporation.

Mr. Smail: May I ask for a stipulation, to avoid calling a witness—I believe there will be no question about it at this time, and if so I would have no further questions. I wonder if Counsel would stipulate with me that Mrs. Helen Jones of the County of Sacramento in the Assessor's office, if called as a witness, would testify that she is in charge of the assessment list or cards on improvements on leased lands and improvements on leased land in the ranch here in question are still in the name on her rolls of Mr. Rooney as an individual and not in the name of the corporation? Would that be agreeable?

Mr. Smith: That would be agreeable.

Mr. Smail: I have verified that this morning. I have no further questions.

Mr. Smith: That is all. We have no further witnesses.

The Court: Plaintiff rests?

Mr. Smith: Plaintiff rests.

Mr. Smail: The United States would like to argue whether a prima facie case has been established here rather seriously. I have no witnesses to call. I think we might be able to argue it just as well in briefs and not take more of the Court's time.

The Court: I was going to say why don't you

make it in the form of a motion and I will take it under advisement, and [62] then you can proceed.

Mr. Smail: I might just take less than two minutes.

The Court: Well, I don't want any argument on it, just state your motion so that you will have your record preserved in that regard.

Mr. Smail: It will be on two grounds: On the first ground we discussed earlier, namely the only question before the Court was the legal power of the Commissioner to reallocate income, and none of this testimony has dealt with that issue, and if that issue is not the one before the Court and we are to consider whether the Commissioner acted arbitrarily or capriciously or unreasonably in reallocating his income, I submit the evidence before your Honor has not made an attack on the Commissioner's allegation here.

It is clear that the crop was harvested in '54, and yet as reported in the two controlled businesses resulted in a loss that wiped out the '54 income of the individual and knocked out almost \$20,000 of the tax paid in 1953, and \$2,000 of the tax paid in 1952. Not only distorting the income for this year, but for the two prior years.

I would submit that no prima facie case has been established that the Commissioner acted unreasonably in allocating this income.

The Court: I will take that under advisement.

Mr. Smail: The United States, after making this motion, [63] will not call any witnesses, and will rest on that.

The Court: The defense rests.

Mr. Smith: If your Honor please, I wonder if the Plaintiff might recall Mr. Howard for the purpose of placing the construction which he intended on the pleadings which he drafted in this case, as Counsel has raised the issue of the proper interpretation of the language employed in the pleadings in this case, that is, the question of without power or without authority, and if we might put Mr. Howard on for that purpose?

Mr. Smail: We don't think the testimony can be introduced.

The Court: I don't think that that is a subject of testimony. I think that, unfortunately, is what I have got to resolve. I wish I could place the responsibility on Mr. Howard's shoulders, but I am afraid the Government probably would not accept that.

Mr. Smith: We felt that it would be illuminating to your Honor, and we would like to introduce it at this time.

The Clerk: Is this a motion for dismissal, or for judgment?

The Court: He has made a motion, I assume, for judgment on the basis that there is no prima facie case shown.

Mr. Smail: Yes. I don't think that there is any evidence here at all, establishing a prima facie case.

The Court: Well, if you think it is desirable, Mr. Smith, [64] to make a record on that, you may do so, but I don't think that I could accept an

attorney's opinion as to what a document means, even though——

Mr. Smith: Not as a legal conclusion, your Honor, but just as the expression of the writer as to that which was in his mind.

The Court: I don't think that that is sufficient though. It is what the document would convey to the average person or to an ordinary person reading it, which is to be controlling, rather than what the person intended.

Mr. Smith: I must agree, your Honor.

The Court: All right. Now, as I have already indicated, I want memos in this matter here. I don't know how one judge can be as lucky as I am, whenever there is something that hasn't been decided in this Circuit it always seems to drift into my Court here.

I assume the burden is on the Plaintiff, so, Mr. Smith, how long do you want for your opening memorandum?

I would suggest to you gentlemen, that you have this record transcribed here this morning, and make it a part of the record in the case, and have everything in black and white.

Mr. Smith: Yes, your Honor.

Mr. Smail: Yes.

The Court: Is that agreeable? [65]

Mr. Smith: Yes, your Honor.

Mr. Smail: Yes, your Honor.

(Discussion between Court and Counsel as to time of filing memorandum.)

(It was ordered that the memorandums be filed 30, 30 and 15, the time to commence upon the date of the filing of the transcript with the Clerk of the Court.)

[Endorsed]: Filed May 3, 1960. [66]

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO
RECORD OF APPEAL

I, James P. Welsh, Clerk of the District Court of the United States for the Northern District of California, do hereby certify that the foregoing and accompanying documents listed below, are the originals filed in this Court, in the above-entitled case, and that they constitute the record on appeal herein as designated by the appellant herein.

Complete Documents, numbered one (1) through and including twenty-four, (24) and Exhibits one (1) and two (2).

In Witness Whereof, I have hereunto set my hand and the seal of said Court this 13th day of February, 1961.

[Seal] JAMES P. WELSH,
Clerk;

By /s/ WILLIAM C. ROBB,
Deputy in Charge.

[Endorsed]: No. 17313. United States Court of Appeals for the Ninth Circuit. Francis L. Rooney, and Irene Rooney, Appellants, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court for the Northern District of California, Northern Division.

Filed Feb. 14, 1961.

Docketed March 29, 1961.

/s/ FRANK H. SCHMID,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

United States Court of Appeals
for the Ninth Circuit

No. 17313

FRANCIS L. ROONEY and IRENE ROONEY,
His Wife,

Plaintiffs and Appellants,

vs.

UNITED STATES OF AMERICA,

Defendant and Appellee.

APPELLANTS' STATEMENT OF
POINTS

To the Clerk of the Above-Entitled Court:

Those portions of the record in the above-entitled proceeding designated by appellants for inclusion in the record on appeal contain all contentions and evidence relevant to the following points which are to be considered on the appeal on this cause:

The District Court erred in its determinations that:

(1) The action of the Commissioner of Internal Revenue in allocating expenses actually incurred by appellants to their successor corporation was a proper exercise of the discretion vested in him by Section 482 of the Internal Revenue Code of 1954;

(2) Appellants were not entitled to deduct the expenses incurred by them individually in connection with the growing of the crop in question and to carry back their net operating loss as permitted by applicable provisions of the Internal Revenue Code of 1939;

(3) Appellants did not qualify for the tax free transfer provisions of Section 351 of the Internal Revenue Code of 1954.

Dated: March 28, 1961.

Respectfully submitted,

/s/ N. RICHARD SMITH,

HOWARD & PRIM,

Attorneys for Appellants.

[Endorsed]: Filed March 29, 1961.

